

Appendix I

This Appendix I to our press release dated June 30, 2004 is organized into the following sections:

- **“Consolidated Results of Operations and Financial Condition”** provides a narrative description of Freddie Mac’s financial performance and condition.
- **“Recent Events and Contingencies”** provides an update on various regulatory, legal and other matters affecting us.
- **“Forward-Looking Statements”** provides cautionary statements about factors that could cause actual results to differ materially from the expectations expressed in our forward-looking statements.

CONSOLIDATED RESULTS OF OPERATIONS AND FINANCIAL CONDITION

The following discussion of our consolidated results of operations and financial condition is organized into three sections:

- “Results of Operations,” which provides an overview of our annual results of operations for 2003, 2002 and 2001 and quarterly results for 2003 and 2002;
- “Consolidated Balance Sheets Analysis,” which discusses changes in our consolidated balance sheets for 2003 and 2002; and
- “Impact of New Accounting Standards or Changes in Accounting,” which provides a description of new accounting standards and changes in our accounting methods.

These sections should be read in conjunction with the Consolidated Financial Statements and Tables that accompany our press release dated June 30, 2004. Additional information about our business and our accounting policies can be found in our Information Statement dated February 27, 2004.

Results of Operations

PERFORMANCE OVERVIEW

Net Income

Net income for 2003, 2002 and 2001 totaled \$4,891 million, \$10,090 million and \$3,158 million, respectively. The decline in net income in 2003 relates primarily to a \$7,402 million decrease in total non-interest income (loss). The decrease in total non-interest income (loss) was composed of:

- Gains of \$39 million on derivatives as compared to gains of \$5,302 million in 2002;
- Losses of (\$1,114) million on investment activities as compared to gains of \$1,799 million in 2002; and
- Losses of (\$1,775) million on the retirement of debt securities as compared to losses of (\$674) million in 2002.

These declines were offset in part by lower losses on guarantee assets, increased income on guarantee obligations and increased hedge accounting gains in 2003.

The increase in net income in 2002 as compared to 2001 was primarily driven by increases in non-interest income (loss), principally higher derivative gains, and net interest income, which were partially offset by higher non-interest expenses.

Net Interest Income

Net interest income totaled \$9,498 million, \$9,525 million and \$7,448 million for 2003, 2002 and 2001, respectively. Net interest income for 2003 was down slightly from 2002, but there were significant offsetting effects during the year among the items comprising this line. Results were favorably impacted by:

- Improvements in our funding costs due to the reduction in interest rates during the first half of 2003;
- 14 percent growth in the average unpaid principal balance, or UPB, of the retained portfolio during 2003; and
- Reduced expense related to interest-rate swaps in hedge accounting relationships.

These positive effects were largely offset by the following:

- Lower yields on new assets acquired as prepayments on higher-yielding assets increased;
- Accelerated amortization of net premiums on mortgage-related securities; and
- Higher expenses due to Participation Certificate, or PC, holders as a result of higher prepayments on the underlying loans.

The liquidation rate is one indicator of the prepayments that drive the accelerated amortization of the net premium or discount on mortgage-related securities and the higher expense due to PC holders. Higher liquidation rates in 2003 drove the retained portfolio yield down, outpacing the benefit of improved funding costs. The annual retained portfolio liquidation rate was 45 percent in 2003 as compared to 32 percent in 2002. The annual liquidation rate on outstanding PCs and Structured Securities increased to 63 percent in 2003 from 47 percent in 2002, contributing to the higher expense due to PC holders.

Amortization of purchase premiums and discounts on mortgage-related securities, which is recognized as a component of net interest income, shifted to a greater amortization expense in 2003 compared to prior years. During 2001, premiums and discounts related to retained portfolio purchases were in a net discount position for the portfolio as a whole. When the retained portfolio is in a net discount position, as it was in 2001, this generally produces net amortization income for the period. However, as interest rates declined during 2002 and into the first half of 2003, we paid premiums on a higher percentage of the mortgage-related securities we acquired, resulting in a shift to a net premium position for the portfolio beginning late in 2002 and an increasing premium position in 2003. When the retained portfolio is in a net premium position, as it was in 2003, amortization generally results in net amortization expense.

Net Interest Yield

Net interest yield on a fully taxable-equivalent basis decreased by 20 basis points to 130 basis points in 2003 from 150 basis points in 2002. The decline in interest rates during 2002 and through the first half of 2003 was a significant driver of the reduction in net interest yield. In 2003, however, the positive effect of these interest rate movements and the maturity of higher cost debt on our funding costs was offset by the effects of accelerated mortgage loan prepayments and the acquisition of new assets in a lower interest-rate environment which lowered the average yield of the portfolio.

In 2002, net interest yield on a fully taxable-equivalent basis increased by 5 basis points, to 150 basis points in 2002 from 145 basis points in 2001. Net interest yield improved in 2002 as lower interest rates led to improved short-term funding costs. This was partially offset by the impact of newly acquired assets in a lower interest rate environment.

Non-Interest Income (Loss)

Non-interest income (loss) totaled (\$259) million, \$7,143 million and (\$1,602) million in 2003, 2002 and 2001, respectively. The volatility in non-interest income (loss) was largely due to items marked to fair value through earnings each year. In 2003, these items included derivatives, mortgage-related securities classified as trading, and guarantee assets. In 2003, guarantee obligations were amortized to non-interest income (loss) pursuant to the adoption of Financial Accounting Standards Board, or FASB, Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for*

Guarantees, Including Indirect Guarantees of Indebtedness of Others, or FIN 45. In 2002 and 2001, prior to the adoption of FIN 45, guarantee obligations were marked to fair value through earnings. Over the past three years, the most significant source of volatility in non-interest income (loss) has been “Derivative gains (losses),” which includes the impact of those derivatives that, although effective in reducing our market risk exposures, are not designated in hedge accounting relationships. We use these derivatives to manage interest rate and other market risks associated with our assets and liabilities. A significant portion of our derivatives is not currently designated in hedge accounting relationships partly as a result of corrections to certain derivatives accounting practices that were made in the restatement of our financial results. Losses on debt retirements increased in 2003 and 2002 as we repurchased increasing amounts of debt securities each year. Non-interest income (loss) also includes management and guarantee income which increased in 2003, as an increase in average PCs outstanding and increased amortization income from buy-downs and credit fees, was partly offset by a decline in contractual guarantee fees received on outstanding PCs.

Non-Interest Expense

Non-interest expense was (\$2,146) million, (\$1,865) million and (\$1,392) million in 2003, 2002 and 2001, respectively. The increase in non-interest expense in 2003 was primarily driven by restatement and remediation efforts in 2003 of \$172 million, a \$125 million civil money penalty paid related to the investigation into matters related to our 2002 restatement by the Office of Federal Housing Enterprise Oversight, or OFHEO, and fees of \$124 million paid on certain multifamily affordable housing transactions. In addition, we began recognizing amortization of credit enhancements and realized losses related to certain guarantees in “Other expenses” in 2003 which totaled \$194 million.

The increase in non-interest expense for 2002 was driven by higher compensation costs and a special contribution of \$225 million to Freddie Mac’s philanthropic program that did not occur in 2003 or 2001.

RISK MEASURES

Interest Rate Sensitivity

We actively manage interest-rate risk and other related market risks and take a disciplined approach to risk management. Our interest-rate risk sensitivity disclosures provide estimates of our exposure to significant changes in the interest rate environment. Portfolio market value sensitivity, or PMVS, estimates the percentage of our fair value of net assets attributable to common stockholders at risk from an immediate adverse change in interest rates. Duration gap is an estimate of the interest-rate sensitivity of our assets and liabilities (including derivative instruments) and expresses the results in months. Throughout 2003, our interest-rate risk remained low. For December 2003, the average daily portfolio PMVS related to the level of interest rates was 3 percent and the average daily duration gap was zero months.

Credit Quality Indicators

The effectiveness of our credit risk management activities is reflected primarily in the level of credit losses relative to the total mortgage portfolio (excluding Freddie Mac mortgage-related securities and that portion of Structured Securities that is backed by Ginnie Mae Certificates). Our single-family credit losses during 2003 declined slightly and remained low as a percentage of the average total mortgage portfolio. These positive results during 2003 were driven by the quality of our total mortgage portfolio and favorable economic conditions, primarily low mortgage rates and continued single-family house-price appreciation. The single-family non-credit-enhanced portfolio delinquency rate improved to 0.27 percent at year-end 2003 from 0.29 percent at year-end 2002. Our single-family credit results also continued to reflect the benefits of automated underwriting, loss mitigation activities, and high levels of credit enhancement we have obtained on our existing mortgage portfolio. Multifamily market vacancy rates continued to rise in 2003, but our portfolio had minimal losses. The total multifamily portfolio delinquency rate improved to 0.05 percent at year-end 2003 from 0.13 percent at year-end 2002.

SUMMARY OF CONSOLIDATED RESULTS

Table 1 summarizes our financial performance for the periods presented.

Table 1: Summary of Consolidated Results

	2003 vs. 2002				2002 vs. 2001		
	Year Ended		Change		Year Ended		Change
	December 31,		Dollar	Percent	December 31,	Dollar	Percent
	2003	2002			2001		
	(in millions, except percents and per share amounts)						
Net interest income	\$ 9,498	\$ 9,525	\$ (27)	- %	\$ 7,448	\$ 2,077	28 %
Non-interest income (loss)							
Management and guarantee income	1,638	1,516	122	8	1,392	124	9
Gains (losses) on "Guarantee asset for Participation Certificates, at fair value"	(1,461)	(2,176)	715	(33)	(789)	(1,387)	176
Income (expense) on "Guarantee obligation for Participation Certificates"	925	592	333	56	203	389	192
Derivative gains (losses)	39	5,302	(5,263)	(99)	(2,313)	7,615	(329)
Hedge accounting gains (losses)	644	187	457	244	(294)	481	(164)
Gains (losses) on investment activity	(1,114)	1,799	(2,913)	(162)	191	1,608	842
Gains (losses) on debt retirement	(1,775)	(674)	(1,101)	163	(356)	(318)	89
Resecuritization fees	352	276	76	28	135	141	104
Other income	493	321	172	54	229	92	40
Total non-interest income (loss)	(259)	7,143	(7,402)	(104)	(1,602)	8,745	(546)
Non-interest expense							
Provision for credit losses	(10)	(128)	118	(92)	(32)	(96)	300
REO operations income (expense)	23	13	10	77	(7)	20	(286)
Salaries and employee benefits	(624)	(593)	(31)	5	(537)	(56)	10
Occupancy expense	(52)	(42)	(10)	24	(35)	(7)	20
Housing tax credit partnerships	(200)	(160)	(40)	25	(121)	(39)	32
Minority interest in earnings of consolidated subsidiaries	(157)	(184)	27	(15)	(208)	24	(12)
Other expenses	(1,126)	(771)	(355)	46	(452)	(319)	71
Total non-interest expense	(2,146)	(1,865)	(281)	15	(1,392)	(473)	34
Income before income tax expense and cumulative effect of change in accounting principles	7,093	14,803	(7,710)	(52)	4,454	10,349	232
Income tax expense	(2,202)	(4,713)	2,511	(53)	(1,339)	(3,374)	252
Income before cumulative effect of change in accounting principles, net of taxes	4,891	10,090	(5,199)	(52)	3,115	6,975	224
Cumulative effect of change in accounting principles, net of taxes	-	-	-	-	43	(43)	(100)
Net income	4,891	10,090	(5,199)	(52)	3,158	6,932	220
Preferred stock dividends	(216)	(234)	18	(8)	(217)	(17)	8
Net income available to common stockholders	\$ 4,675	\$ 9,856	\$ (5,181)	(53) %	\$ 2,941	\$ 6,915	235 %
Diluted earnings per common share after cumulative effect of change in accounting principles, net of taxes	\$ 6.79	\$ 14.18	\$ (7.39)	(52) %	\$ 4.23	\$ 9.95	235 %

NET INTEREST INCOME

Net interest income, our principal source of earnings, is the difference between interest income and interest expense. Net interest income is affected by changes in the balance and contractual rates associated with our interest-bearing assets, liabilities and derivative contracts, as adjusted for amortization of purchase premiums and discounts and amortization of deferred hedging gains and losses as explained later in “Analysis of Quarterly Results.” We analyze net interest income, and the related net interest yield, on a taxable-equivalent basis to consistently reflect income from taxable and tax-exempt investments based on a 35 percent marginal tax rate.

In 2003, in accordance with recent interpretive guidance published by the Office of the Chief Accountant of the U.S. Securities and Exchange Commission, or SEC, we reclassified the accrual of periodic cash settlements in accordance with the contractual terms of derivatives not designated in hedge accounting relationships from “Income (expense) related to derivatives,” a component of “Net interest income,” to “Derivative gains (losses),” a component of “Non-interest income (loss).” These amounts have also been reclassified in all prior periods to conform to the 2003 presentation. See “Impact of New Accounting Standards or Changes in Accounting – Non-Hedging Derivatives” for more information.

2003 versus 2002

Table 2 summarizes net interest income for 2003 compared to 2002, and the related analysis of the effect of changes in the rates and volumes of our interest-bearing assets and liabilities on the changes in net interest income between 2003 and 2002.

Table 2: Net Interest Income, or NII, and Rate/Volume Analysis (2003 compared to 2002)

	2003		2002		Increase (Decrease) to NII	Attributable to Changes in ⁽¹⁾	
	NII	Yield	NII	Yield		Rate	Volume
	(dollars in millions)						
Interest income:							
Mortgage loans	\$ 4,251	6.70 %	\$ 4,290	7.02 %	\$ (39)	\$ (199)	\$ 160
Mortgage-related securities	29,051	5.34	30,039	6.38	(988)	(5,325)	4,337
Total retained portfolio	33,302	5.48	34,329	6.46	(1,027)	(5,524)	4,497
Cash and investments	3,796	2.63	4,147	3.41	(351)	(718)	367
Total interest-earning assets	37,098	4.93	38,476	5.89	(1,378)	(6,242)	4,864
Interest expense:							
Short-term debt	(2,785)	(1.21)	(4,303)	(2.03)	1,518	1,849	(331)
Long-term debt	(22,083)	(4.62)	(21,337)	(5.24)	(746)	2,725	(3,471)
Total interest expense on debt securities	(24,868)	(3.52)	(25,640)	(4.15)	772	4,574	(3,802)
Due to Participation Certificate investors	(1,641)	(6.26)	(1,236)	(6.82)	(405)	110	(515)
Total expense on interest-bearing liabilities	(26,509)	(3.62)	(26,876)	(4.23)	367	4,684	(4,317)
Income (expense) related to derivatives ⁽²⁾	(1,091)	(0.15)	(2,075)	(0.32)	984	984	-
Impact of net non-interest-bearing funding	-	0.10	-	0.13	-	-	-
Net interest income ⁽²⁾⁽³⁾	9,498	1.27	9,525	1.46	(27)	(574)	547
Fully taxable-equivalent adjustment	227	0.03	252	0.04	(25)	9	(34)
Net interest income (fully taxable-equivalent basis) ⁽²⁾⁽³⁾	<u>\$ 9,725</u>	<u>1.30 %</u>	<u>\$ 9,777</u>	<u>1.50 %</u>	<u>\$ (52)</u>	<u>\$ (565)</u>	<u>\$ 513</u>

⁽¹⁾ Combined rate/volume changes are allocated to the individual rate and volume changes based on their relative size.

⁽²⁾ In 2003 we reclassified the accrual of periodic cash settlements in accordance with the contractual terms of derivatives not designated in hedge accounting relationships from "Income (expense) related to derivatives" to "Derivative gains (losses)." For comparative purposes, we reclassified \$639 million of expense from "Income (expense) related to derivatives" to "Derivative gains (losses)" in 2002.

⁽³⁾ May not sum due to rounding.

Net interest income on a fully taxable-equivalent basis decreased by \$52 million to \$9,725 million in 2003 from \$9,777 million in 2002. During 2003, interest income on mortgage-related securities declined by \$988 million, or 3 percent. The interest income generated by the 14 percent growth in the UPB of the retained portfolio was more than offset by: the accelerated amortization of higher net premiums on these securities, lower yields on assets acquired due to the low interest rate environment during 2003, as well as the continued liquidation of higher-yielding assets during 2003. Net interest income and

net interest yield were reduced as the yield on interest-earning assets declined at a faster rate than the cost of debt funding during 2003. During the first quarter of 2003, we refined the assumptions and calculations for the amortization of deferred fees recorded as discounts on assets in our retained portfolio. The effect on net interest income of refining these assumptions, which was treated as a change in estimate and also impacted management and guarantee income, was the recognition of \$31 million of additional amortization income during the first quarter of 2003. Interest income related to cash and investments declined by \$351 million, or 8 percent, during 2003 as the negative impact of declining interest rates during the first half of 2003 was only partially offset by the 19 percent increase in the average balances of cash and investments during 2003.

Declining short-term interest rates during the first half of 2003 were the primary factor in the decline in interest expense related to short-term debt for the year of \$1,518 million, or 35 percent, which was only partially offset by an 8 percent increase in the average balances of short-term debt during the year. Interest expense related to long-term debt increased by \$746 million, or 3 percent, during 2003 as the average balances of long-term debt increased by 17 percent, which offset the benefit of issuing new debt at lower rates. We repurchased approximately \$27 billion of long-term debt during 2003 and issued new debt at lower average rates in most cases. The most significant debt repurchases in 2003 occurred in the second quarter when we repurchased an aggregate of approximately \$17 billion of U.S. dollar and Euro-denominated debt securities, most of which followed the announcement of changes in our senior management. We executed these particular repurchases in an effort to support the liquidity and price performance of these securities. Gains and losses on debt retirement are reported as a component of non-interest income (loss).

Interest expense related to amounts due to Participation Certificate investors increased \$405 million to (\$1,641) million in 2003 from (\$1,236) million in 2002 as prepayments on the collateral underlying PCs accelerated during the first part of 2003 in response to declining interest rates. The liquidation rate on outstanding PCs and Structured Securities increased to 63 percent in 2003 from 47 percent in 2002. For a further discussion of how the prepayments of the collateral underlying PCs affect net interest income, see “Analysis of Quarterly Results – Interest expense related to amounts due to Participation Certificate investors.”

“Income (expense) related to derivatives,” which includes the accrual of periodic cash settlements on interest-rate swap transactions accounted for as hedges and amortization of net deferred losses on closed cash flows hedges, improved by \$984 million, decreasing to (\$1,091) million in 2003 from (\$2,075) million in 2002. During 2002 and into 2003, we terminated pay-fixed swaps to manage the funding mismatch caused by the decrease in the expected lives of mortgage investments and an increase in the balance of long-term debt. In 2002, the portfolio of swaps designated in hedge accounting relationships was in a net pay-fixed position, which resulted in increasing interest expense as market interest rates declined.

Net interest yield on a fully taxable-equivalent basis decreased by 20 basis points to 130 basis points in 2003 from 150 basis points in 2002. For 2003, net interest yield was lower as declines in yields on interest-earning assets outpaced the benefit of lower funding costs. The net interest yield on interest-earning assets declined as a result of high liquidations in the first three quarters of 2003 and the acquisition of new assets in a lower rate environment. The net interest yield on debt securities declined as the result of our long-term debt retirements, primarily in the second quarter of 2003, and subsequent refinance activity primarily benefiting short-term funding costs. Overall net interest yield declined as our interest-earning assets repriced faster than our debt.

2002 versus 2001

Table 3 summarizes net interest income for 2002 compared to 2001, and the related rate/volume analysis for the changes between 2002 and 2001.

Table 3: Net Interest Income and Rate/Volume Analysis (2002 compared to 2001)

	2002		2001		Increase (Decrease) to NII	Attributable to Changes in ⁽¹⁾	
	NII	Yield	NII	Yield		Rate	Volume
	(dollars in millions)						
Interest income:							
Mortgage loans	\$ 4,290	7.02 %	\$ 4,385	7.22 %	\$ (95)	\$ (118)	\$ 23
Mortgage-related securities	30,039	6.38	26,847	6.92	3,192	(2,203)	5,395
Total retained portfolio	34,329	6.46	31,232	6.96	3,097	(2,321)	5,418
Cash and investments	4,147	3.41	4,136	4.82	11	(1,448)	1,459
Total interest-earning assets	38,476	5.89	35,368	6.62	3,108	(3,769)	6,877
Interest expense:							
Short-term debt	(4,303)	(2.03)	(9,056)	(4.23)	4,753	4,670	83
Long-term debt	(21,337)	(5.24)	(17,494)	(6.00)	(3,843)	2,416	(6,259)
Total interest expense on debt securities	(25,640)	(4.15)	(26,550)	(5.25)	910	7,086	(6,176)
Due to Participation Certificate investors	(1,236)	(6.82)	(1,027)	(7.27)	(209)	66	(275)
Total expense on interest-bearing liabilities	(26,876)	(4.23)	(27,577)	(5.31)	701	7,152	(6,451)
Income (expense) related to derivatives ⁽²⁾	(2,075)	(0.32)	(343)	(0.07)	(1,732)	(1,732)	-
Impact of net non-interest-bearing funding	-	0.13	-	0.17	-	-	-
Net interest income ⁽²⁾⁽³⁾	9,525	1.46	7,448	1.41	2,077	1,651	426
Fully taxable-equivalent adjustment	252	0.04	237	0.04	15	4	11
Net interest income (fully taxable-equivalent basis) ⁽²⁾⁽³⁾	<u>\$ 9,777</u>	<u>1.50 %</u>	<u>\$ 7,685</u>	<u>1.45 %</u>	<u>\$ 2,092</u>	<u>\$ 1,655</u>	<u>\$ 437</u>

⁽¹⁾ Combined rate/volume changes are allocated to the individual rate and volume changes based on their relative size.

⁽²⁾ In 2003 we reclassified the accrual of periodic cash settlements in accordance with the contractual terms of derivatives not designated in hedge accounting relationships from "Income (expense) related to derivatives" to "Derivative gains (losses)." For comparative purposes, we reclassified \$639 million and \$456 million of expense from "Income (expense) related to derivatives" to "Derivative gains (losses)" in 2002 and 2001, respectively.

⁽³⁾ May not sum due to rounding.

Net interest income on a fully taxable-equivalent basis increased \$2,092 million, or 27 percent, to \$9,777 million in 2002 from \$7,685 million in 2001. The increase in net interest income was primarily due to a continuation during 2002 of the steep yield curve environment that existed in 2001. A steepening yield curve means that short-term interest rates are decreasing more than long-term rates, or are increasing at a slower rate than long-term rates. The decrease in short-term interest rates during 2002 coupled with the steepening yield curve resulted in a reduction in short-term debt costs and wider initial mortgage-to-debt spreads on additions to the retained portfolio. An increase of \$83 billion, or 18 percent, in the average balance of the retained portfolio in 2002 also contributed to the increase in net interest income (see “Consolidated Balance Sheets Analysis – Retained Portfolio” for a discussion regarding changes in the balance of the retained portfolio).

The positive effects of the steep yield curve and retained portfolio growth on net interest income were offset by higher expenses related to the accrual of periodic cash settlements of derivatives in hedge accounting relationships and increased amortization expense associated with (i) net purchase premiums on mortgage-related investments and (ii) deferred hedging losses related to terminated pay-fixed swaps recorded in “Accumulated other comprehensive income (loss), net of taxes,” or AOCI. The increase in amortization expense was caused by decreases in long-term rates during 2002, which shortened the expected lives of mortgage-related investments resulting in accelerated amortization of related premiums. In addition, we terminated pay-fixed swaps in cash flow hedge accounting relationships in loss positions resulting in increased amortization expense related to closed hedge positions. As discussed in “Consolidated Balance Sheets Analysis – Total Debt Securities, Net,” the termination of these pay-fixed swaps shortened the effective duration of our liabilities to address the decrease in the expected lives of mortgage investments. For further information regarding amortization of premiums, discounts and hedging gains and losses, see “Analysis of Quarterly Results” below.

Net interest yield on a fully taxable-equivalent basis increased by 5 basis points to 150 basis points in 2002 from 145 basis points in 2001. This relatively small change in net interest yield was the net result of the effects of the steep yield curve, increased amortization expense and the shift in the mix of interest-earning assets toward cash and investments which typically generates relatively lower yields. The average balance of cash and investments increased by 42 percent, fueled by cash inflows from prepayments on outstanding PCs. Limited retained portfolio investment opportunities during certain periods of 2002 also contributed to growth in the average balance of cash and investments.

Analysis of Quarterly Results

Table 4 summarizes quarterly net interest income and net interest yield for 2003 and 2002.

Table 4: Quarterly Net Interest Income (quarterly yields annualized)

	1Q 2003	2Q 2003	3Q 2003	4Q 2003	2003
	(dollars in millions)				
Net interest income	\$ 2,421	\$ 2,185	\$ 2,442	\$ 2,450	\$ 9,498
Fully taxable-equivalent adjustment	41	64	60	62	227
Net interest income (fully taxable-equivalent basis)	\$ 2,462	\$ 2,249	\$ 2,502	\$ 2,512	\$ 9,725
Net interest yield (fully taxable-equivalent basis)	1.40%	1.26%	1.27%	1.26%	1.30%
	(dollars in millions)				
	1Q 2002	2Q 2002	3Q 2002	4Q 2002	2002
Net interest income ⁽¹⁾	\$ 2,544	\$ 2,352	\$ 2,231	\$ 2,398	\$ 9,525
Fully taxable-equivalent adjustment	66	65	66	55	252
Net interest income (fully taxable-equivalent basis) ⁽¹⁾	\$ 2,610	\$ 2,417	\$ 2,297	\$ 2,453	\$ 9,777
Net interest yield (fully taxable-equivalent basis) ⁽¹⁾	1.67%	1.53%	1.41%	1.41%	1.50%

⁽¹⁾ In 2003 we reclassified the accrual of periodic cash settlements in accordance with the contractual terms of derivatives not designated in hedge accounting relationships from "Income (expense) related to derivatives" to "Derivative gains (losses)." For comparative purposes, we reclassified expense of \$130 million, \$229 million, \$152 million and \$128 million for 1Q 2002, 2Q 2002, 3Q 2002 and 4Q 2002, respectively, and \$639 million for full-year 2002 from "Income (expense) related to derivatives" to "Derivative gains (losses)."

Changes in quarterly net interest income and net interest yield in 2003 and 2002 were driven primarily by changes in interest rates and growth in the retained portfolio, as described above in the analysis of annual results. Other drivers of net interest income and yields are described in detail below, followed by a tabular presentation (see Table 5) discussing the impact of these drivers on net interest income during the quarterly periods of 2003 and 2002.

- Investment asset mix.** The purchase, sale and liquidation activity of assets within the retained portfolio and the cash and investments portfolio has a significant impact on our overall net interest yield. As the composition of the portfolio changes between higher or lower yielding asset types, the overall net asset yield on these portfolios fluctuates. Generally, during periods of declining interest rates, as we experienced in 2002 and the first half of 2003, the yield on portfolio assets will decline as higher-yielding assets liquidate and new assets are acquired at lower rates. The opposite effect is generally seen when interest rates rise, as the pace of liquidations slows and new assets are acquired at higher rates. Changes in portfolio interest yields occur when there is a shift in the proportion of higher-yielding asset types to lower-yielding asset types. For example, the mortgage-related securities portfolio net interest yield will decline if there is an increase in the amount of lower-yielding mortgages such as 15-year mortgage-

related securities or adjustable rate mortgage-related securities as compared to higher-yielding 30-year fixed-rate loans.

- **Amortization of premiums and discounts.** When we purchase mortgage-related securities, the price we pay for the assets generally does not equal the security UPB. We pay more than the UPB (referred to as a premium) when the coupon on the security is greater than the current market yield for that security. We pay less than the UPB (referred to as a discount) when the coupon on the security is less than the current market yield for that security. As interest rates declined during 2002 and the first half of 2003, the total premiums we paid increased on the mortgage-related securities we acquired. This resulted in a shift in the portfolio to a net premium position late in 2002, and an increasing premium position in 2003.

Purchase premiums and discounts are amortized over the estimated life of the purchased assets as adjustments to interest income primarily based on the effective interest method in accordance with Statement of Financial Accounting Standards, or SFAS, No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, or SFAS 91. This method of amortization results in periodic adjustments to interest income when the effective interest rate changes due to differences between actual and estimated prepayments and changes in estimated future prepayments.

- **Amortization of hedging gains and losses.** Certain derivative contracts (primarily pay-fixed swaps) are accounted for as cash flow hedges of the variability of interest payments on forecasted debt issuances, while other derivative contracts (primarily receive-fixed swaps) are accounted for as fair value hedges of existing debt. In both cases, termination of the hedge accounting relationship results in the associated deferred hedging gain or loss being amortized into net interest income. Amortization related to terminated cash flow hedges is generally included in “Income (expense) related to derivatives” or, if the deferred gain or loss is related to a closed cash flow hedge on long-term debt, in “Interest expense on long-term debt.” The amortization related to terminated fair value hedges is also included in “Interest expense on long-term debt.”
- **Interest expense related to amounts due to Participation Certificate investors.** As a result of the payment remittance cycle associated with PCs, interest expense related to amounts due to PC investors tends to increase during periods of rising prepayments and decrease during periods of declining prepayments. We invest the proceeds from prepayments on PCs in short-term investments until related payments are due to PC investors. The interest earned on these investments is reported as a component of interest income on cash and investments. As short-term rates declined in 2002 and the first half of 2003, prepayments accelerated and our interest costs due to PC investors increased while the interest earnings on our related investments declined. This had an overall negative impact on “Net interest income.”

- **Debt funding mix.** As discussed in “Consolidated Balance Sheets Analysis – Total Debt Securities, Net,” we adjust the composition of our derivative portfolio to address differences between outstanding debt, scheduled debt issuances and our funding needs. Due to declining interest rates in 2002 and the first half of 2003, the expected lives of assets held in the retained portfolio decreased, requiring us to reduce the duration of our long-term debt funding from an asset/liability management perspective. However, the volume of long-term debt issued is generally determined by our commitment to our Reference Notes securities calendar. In 2002 and the first half of 2003, to shorten the effective duration of our debt and thereby manage the funding mismatch created by the decline in interest rates, we terminated certain pay-fixed swaps and entered into receive-fixed swaps. Receive-fixed swaps effectively convert a fixed-rate debt payment into a variable-rate payment. Conversely, a pay-fixed swap requires us to make a fixed interest payment in exchange for a variable rate payment. In the third quarter of 2003, we entered into additional pay-fixed swaps to extend the duration of our debt portfolio as interest rates increased.

Table 5 describes the effect of these factors on changes in quarterly net interest income on a fully taxable-equivalent basis.

Table 5: Explanation of Quarterly Changes in Net Interest Income and Net Interest Yield

Period	Increase (Decrease) in Net Interest Income (in millions)	Increase (Decrease) in Net Interest Yield (in bps)	Comments
2Q02 vs. 1Q02	\$(193)	(14)	Decreases were driven by a continued shift in debt funding from short-term debt to long-term debt and increased amortization of deferred hedging losses resulting from terminated pay-fixed swaps, as described above in “Debt funding mix.”
3Q02 vs. 2Q02	(120)	(12)	Decreases were due to increased amortization expense related to deferred premiums on retained portfolio purchases and deferred hedging losses associated with terminated pay-fixed swaps. As discussed above in “Amortization of premiums and discounts,” the deferred amount related to the retained portfolio shifted to a net premium position in 2002. The associated increase in amortization expense was partially offset by an increase in interest income from derivative contracts as a result of increases in the notional amount of receive-fixed swaps in hedge accounting relationships.

Table 5: Explanation of Quarterly Changes in Net Interest Income and Net Interest Yield (continued)

Period	Increase (Decrease) in Net Interest Income (in millions)	Increase (Decrease) in Net Interest Yield (in bps)	Comments
4Q02 vs. 3Q02	\$156	-	The increase in net interest income was driven by the recognition of amortization income in the fourth quarter as compared to expense in the third quarter and interest income on derivative contracts, partially offset by increased interest expense related to amounts due to PC investors. The increase in amortization income was primarily due to a \$305 million adjustment related to enhancements made in the fourth quarter of 2002 to our method of estimating prepayments of the collateral underlying our mortgage-related securities. The increase in interest income on derivative contracts was due to an increase in the notional amount of receive-fixed swaps. Interest expense on amounts due to PC investors increased as the liquidation rate on total PCs issued increased in the fourth quarter of 2002.
1Q03 vs. 4Q02	9	(1)	The increase in net interest income related to a decrease in short-term debt expense as a result of declining interest rates and higher interest income related to derivatives due to an increase in volume of receive-fixed swaps. Partially offsetting these increases was higher amortization expense related to net deferred premiums on mortgage investments purchases. In addition, lower yields were recognized on the investment portfolio as short-term rates remained low. During the first quarter of 2003, we refined the assumptions and calculations for the amortization of deferred fees recorded as discounts on assets in our retained portfolio. The effect on net interest income of refining these assumptions, which was treated as a change in estimate and also impacted management and guarantee income, was the recognition of \$31 million of additional amortization income during the first quarter of 2003. Although yields on assets were declining faster than debt costs, the margin reduction was offset by the rate impact of lower derivative expenses.

Table 5: Explanation of Quarterly Changes in Net Interest Income and Net Interest Yield (continued)

Period	Increase (Decrease) in Net Interest Income (in millions)	Increase (Decrease) in Net Interest Yield (in bps)	Comments
2Q03 vs. 1Q03	\$(213)	(14)	Decreases were driven by increases in amortization expense related to deferred premiums on mortgage investment purchases. As discussed above in “Amortization of premiums and discounts,” the deferred amount related to the total retained portfolio was in a net premium position and liquidations increased in the quarter. Also, increased liquidations on PCs outstanding generated timing differences between amounts due from servicers and amounts due to PC investors resulting in increased interest expense. The liquidation rate on total PCs issued increased from 59 percent in the first quarter of 2003 to 74 percent in the second quarter of 2003. Partially offsetting the negative effects above was lower long-term debt expense due to large debt retirements completed in the second quarter. Net interest yield declined as amortization expenses and lower asset yields outpaced lower funding costs.
3Q03 vs. 2Q03	253	1	Increases were driven by lower amortization expense resulting from adjustments to the amortization of the related deferred premiums in the retained portfolio as mortgage rates and estimates of weighted average mortgage lives increased. Net interest income also benefited from decreases in long-term debt expense and net growth in the retained portfolio. Interest expense on derivative contracts increased with purchases of additional pay-fixed swaps typically acquired in a rising rate environment, which were designated in hedge accounting relationships. Net interest yield remained relatively flat as the decline in our debt costs was offset by the decline in asset yields and an increase in expense related to derivatives.
4Q03 vs. 3Q03	10	(1)	Increases to net interest income were due to increased interest income recognized on the mortgage investment portfolio as the average balance of the retained portfolio increased by 5 percent quarter-over-quarter, offset by increased long-term debt expense related to the funding of the retained portfolio growth. Net interest yield remained relatively flat as improved funding costs were offset by lower asset yields.

NON-INTEREST INCOME (LOSS)

Management and Guarantee Income

Management and guarantee income primarily represents the contractual guarantee fees we receive on mortgage-related securities issued and guaranteed by us and held by third party investors. For securities we hold, the associated components of guarantee income are included in "Net interest income." Management and guarantee income also includes amortization of deferred fees, including credit fees and buy-down fees on these securities if they had not previously been sold under SFAS 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," or SFAS 125, or under SFAS 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," or SFAS 140, or previously been subject to guarantee accounting under FIN 45.

Table 6 provides summary information about management and guarantee income for 2003, 2002 and 2001. The total management and guarantee rate consists of the contractual management and guarantee fee rate as adjusted for amortization of deferred fees, including credit fees and buy-down fees.

Table 6: Management and Guarantee Income

	2003		2002		2001	
	Amount	Rate	Amount	Rate	Amount	Rate
	(dollars in millions, rate in basis points)					
Contractual management and guarantee fees	\$ 1,229	17.3	\$ 1,335	19.4	\$ 1,277	21.7
Amortization of deferred fees	409	5.7	181	2.6	115	1.9
Total management and guarantee income	<u>\$ 1,638</u>	<u>23.0</u>	<u>\$ 1,516</u>	<u>22.0</u>	<u>\$ 1,392</u>	<u>23.6</u>
Average outstanding PCs ⁽¹⁾	<u>\$ 711,011</u>		<u>\$ 687,942</u>		<u>\$ 589,772</u>	

⁽¹⁾ Average outstanding PCs were calculated by including PCs and Structured Securities (as defined in our 2002 Information Statement dated February 27, 2004) that are backed by non-agency mortgage-related securities held by third parties.

Management and guarantee income increased by \$122 million, or 8 percent, to \$1,638 million in 2003 from \$1,516 million in 2002. This increase in guarantee income was driven by a 3 percent increase in average outstanding PCs and an increase in the average management and guarantee rate recognized in 2003.

The total management and guarantee rate recognized in 2003 was 23.0 basis points compared with 22.0 basis points in 2002. The increase in the total management and guarantee rate between 2003 and 2002 was driven by accelerated amortization of deferred fees, partially offset by lower contractual management and guarantee fee rates on new business. Deferred fees are amortized over the estimated life of the mortgages underlying PCs using the effective interest method and periodic adjustments to deferred

fee amortization are made to reflect differences between actual and estimated mortgage prepayments and changes in estimated future prepayments. Increased amortization of deferred fees resulted from the decline in mortgage interest rates during the first half of 2003 and the related increase in mortgage prepayments as well as a first quarter 2003 change in the prepayment models used to determine the weighted average lives of outstanding PCs, as discussed below.

In the first quarter of 2003, we improved our methodology for estimating the expected weighted average lives of mortgages with related deferred fees, including credit fees and buy-down fees. The change in estimate included enhancements to the prepayment models we use to determine the expected weighted average lives of mortgage loans underlying our PCs, which in turn are used to calculate the recognition of deferred fees based on the effective interest method required by SFAS 91. Under this method, we use actual prepayment experience and estimates of future prepayments to determine, and subsequently adjust, a constant yield necessary to properly apply the effective interest method. These improvements to our models were treated as a change in estimate in accordance with Accounting Principles Board Opinion No. 20, *Accounting Changes*, and resulted in the recognition of \$110 million of additional amortization income in management and guarantee income in the first quarter of 2003.

The accelerated amortization of deferred fees in 2003 was partially offset by a decline in the contractual guarantee fees received in 2003. The decline in contractual guarantee fees received was driven generally by portfolio turnover, resulting in a decrease in the average contractual guarantee fee rate to 17.3 basis points in 2003 from 19.4 basis points in 2002. The portfolio turnover in 2003 was characterized by decreases in rates on new guarantees, as well as high turnover of seasoned loans with rates higher than the portfolio average. The decrease in contractual rates on new guarantees was driven by an increase in the issuance of 15-year PCs which generally have lower credit risk and thus a lower management and guarantee fee rate relative to 30-year PCs, as well as competitive pricing pressures. Turnover of seasoned loans with higher contractual rates resulted in a decrease in the proportion of loans with buy-ups. Buy-ups are upfront payments we make, which increase the contractual guarantee fees that we receive over the life of the PC in connection with its guarantee.

As of December 31, 2003 and 2002, 81 percent and 54 percent, respectively, of outstanding PCs and Structured Securities had a related guarantee asset and guarantee obligation established. Deferred fees related to these securities have either been recognized in connection with a PC sales transaction or included as part of the guarantee obligation (see “Consolidated Balance Sheets Analysis – Guarantee Obligation for Participation Certificates,” for additional information about guarantee obligations). As of December 31, 2003 and 2002, 19 percent and 46 percent, respectively, of outstanding PCs and Structured Securities had deferred fees accounted for as a deferred liability, which are currently being amortized into management and guarantee income. On January 1, 2003, we implemented FIN 45 and began amortizing the deferred fees related to PC issuances after this date into income as part of “Income (expense) on ‘Guarantee obligation for Participation Certificates’” to the extent that related transfers of such PCs

to third parties were not accounted for pursuant to SFAS 140. Therefore, the amount of the deferred liability from prior years that remains to be amortized into management and guarantee income has been decreasing.

In 2002, management and guarantee income increased \$124 million, or 9 percent, compared to 2001. This increase in guarantee income was driven by a 17 percent increase in average outstanding PCs. The decrease in the total management and guarantee rate between 2002 and 2001 was driven by lower contractual guarantee fee rates, partially offset by accelerated revenue recognition of deferred fees due to high levels of mortgage prepayments.

Table 7 summarizes management and guarantee income and rates for each quarter in 2003 and 2002.

Table 7: Quarterly Management and Guarantee Income

	1Q 2003		2Q 2003		3Q 2003		4Q 2003	
	Amount	Rate	Amount	Rate	Amount	Rate	Amount	Rate
	(dollars in millions, rate in basis points)							
Contractual management and guarantee fees	\$ 314	17.3	\$ 311	17.4	\$ 296	17.3	\$ 309	17.1
Amortization of deferred fees	244	13.5	165	9.3	(61)	(3.5)	60	3.3
Total management and guarantee income	<u>\$ 558</u>	<u>30.8</u>	<u>\$ 476</u>	<u>26.7</u>	<u>\$ 235</u>	<u>13.8</u>	<u>\$ 369</u>	<u>20.4</u>
Average outstanding PCs ⁽¹⁾	<u>\$ 724,751</u>		<u>\$ 712,754</u>		<u>\$ 682,103</u>		<u>\$ 724,436</u>	
	1Q 2002		2Q 2002		3Q 2002		4Q 2002	
	Amount	Rate	Amount	Rate	Amount	Rate	Amount	Rate
	(dollars in millions, rate in basis points)							
Contractual management and guarantee fees	\$ 326	20.3	\$ 341	19.9	\$ 340	19.2	\$ 328	18.3
Amortization of deferred fees	46	2.9	44	2.5	30	1.7	61	3.4
Total management and guarantee income	<u>\$ 372</u>	<u>23.2</u>	<u>\$ 385</u>	<u>22.4</u>	<u>\$ 370</u>	<u>20.9</u>	<u>\$ 389</u>	<u>21.7</u>
Average outstanding PCs ⁽¹⁾	<u>\$ 640,816</u>		<u>\$ 686,180</u>		<u>\$ 708,003</u>		<u>\$ 716,770</u>	

⁽¹⁾ Average outstanding PCs were calculated by including PCs and Structured Securities that are backed by non-agency mortgage-related securities held by third parties.

As described above, the total management and guarantee rate represents the contractual management and guarantee fee rate as adjusted for amortization of deferred fees, including credit fees and buy-down fees. The amortization component of management and guarantee income representing the recognition of deferred fees is based on the effective interest method required by SFAS 91, which requires estimating the expected weighted average lives of mortgages with related deferred fees. The use of the effective interest method requires periodic adjustments to the amortization of deferred

fees, which can cause significant volatility in quarterly income, as both a current period amortization and a cumulative prior period adjustment are recognized in a given period as the effective constant yield changes over time. This volatility is driven primarily by variances between actual and anticipated prepayments, which affects the discount rate applied in determining the effective constant yield.

1Q03 vs. 4Q02

Management and guarantee income increased by \$169 million, or 43 percent, to \$558 million in the first quarter of 2003. This increase was driven primarily by a significant increase in the portion of management and guarantee income representing the amortization of deferred income. The decline in contractual guarantee fees received was primarily attributable to a decrease in the proportion of the portfolio of loans with buy-ups due to the turnover of seasoned loans with higher contractual rates.

The increase in the amortization of deferred income recognized was driven primarily by a decrease in the expected weighted average lives of mortgages underlying our PCs, including the impact of the previously described improvements made to our methodology for estimating the expected weighted average lives of mortgages. These improvements in the quality of our expected weighted average mortgage life estimates resulted in a \$110 million dollar increase in management and guarantee income in the first quarter of 2003.

2Q03 vs. 1Q03

Management and guarantee income decreased by \$82 million, or 15 percent, to \$476 million in the second quarter of 2003. This decrease primarily reflects the effect of the \$110 million adjustment made in the first quarter of 2003 as discussed above. The change in the cash flow portion of management and guarantee income was relatively small, reflective of the 2 percent decrease in average outstanding PCs.

3Q03 vs. 2Q03

Management and guarantee income decreased by \$241 million, or 51 percent, to \$235 million in the third quarter of 2003. This was driven primarily by the fact that amortization expenses were recorded due to the interest rate environment. The change in the contractual guarantee fee portion of management and guarantee income was relatively small, reflective of the 4 percent decrease in average outstanding PCs.

The change in amortization recognition was driven by an approximately 70 basis point increase in the average 30-year mortgage rate during the quarter, which was greater than previously expected. The resulting increase in the effective constant yield necessary to apply the effective interest method required by SFAS 91 caused us to recognize net amortization expense instead of income in the third quarter of 2003.

4Q03 vs. 3Q03

Management and guarantee income increased by \$134 million, or 57 percent, to \$369 million in the fourth quarter of 2003. This increase was driven primarily by an increase in the portion of management and guarantee income representing the amortization of deferred income. The change in amortization recognition was driven by a return to income amortization after the downward adjustment made to amortization in the third quarter, together with a decrease in the expected weighted average lives of mortgages underlying our PCs. The change in the contractual guarantee fee portion of management and guarantee income was reflective of the 6 percent increase in average outstanding PCs.

In 2002, quarterly changes in management and guarantee income and rates were primarily driven by declining contractual management and guarantee fee rates and fluctuations in the rate of revenue recognition due to the amortization of deferred fees. During 2002, mortgage interest rates fluctuated and mortgage prepayments and prepayment expectations increased significantly in periods of falling rates. Declining mortgage rates drove high mortgage prepayment levels and resulted in accelerated recognition of deferred fees. The accelerated amortization of deferred fees was offset by the declining contractual guarantee fee component of management and guarantee fee rates on new business.

Gains (Losses) on Guarantee Asset

“Gains (losses) on ‘Guarantee asset for Participation Certificates, at fair value’” represents the change in fair value of the guarantee asset.

The change in fair value of the guarantee asset reflects:

- The portion of cash received that is considered return of our recorded investment in the guarantee asset; and
- Changes in the fair value of expected future cash inflows.

Gains (losses) on guarantee asset were (\$1,461) million, (\$2,176) million and (\$789) million in 2003, 2002 and 2001, respectively.

Factors Affecting the Fair Value of the Guarantee Asset. With the passage of time, actual cash flows are realized and no longer included in the valuation of the guarantee asset. Cash flows received, which are recorded in management and guarantee income, represent a reduction of our investment in the guarantee asset. As depicted in *Table 8*, cash flows received on the guarantee asset are allocated between interest income (imputed income on the asset based on the discount rate used in the calculation of the fair value of the guarantee asset) and return of investment (the portion of actual cash flows that represents a reduction of the guarantee asset receivable). Because the cash flows are reported as income based on the nature of the cash flows (i.e., management and guarantee

fee income) and not as a direct reduction in the guarantee asset, realized cash flows result in a corresponding change in the valuation of the guarantee asset.

The gain or loss due to changes in the value of future expected cash flows is the second component of the change in the fair value of the guarantee asset. The value of expected cash flows is driven by the estimated lives of the mortgages underlying the outstanding PCs and other economic factors that influence the amount and timing of the future cash flows, such as changes in expected interest rates. Changes in the estimated lives of the underlying mortgages affect the value of the guarantee asset because our right to receive guarantee fees ceases when the underlying mortgages prepay.

The portion of the gains and losses on the guarantee asset attributable to these two factors is shown in *Table 8* below. See “Table 17: Changes in Guarantee Asset” in “Consolidated Balance Sheets Analysis – Guarantee Asset for Participation Certificates” for additional information about the guarantee asset.

Table 8: Attribution of Change in Fair Value – Guarantee Asset

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(dollars in millions)		
Total cash flows received	\$ (888)	\$ (820)	\$ (803)
Portion of cash flows received related to imputed interest	<u>244</u>	<u>259</u>	<u>273</u>
Return of investment in guarantee assets	(644)	(561)	(530)
Change in fair value of future cash flows	<u>(817)</u>	<u>(1,615)</u>	<u>(259)</u>
Gains (losses) on guarantee asset	<u>\$ (1,461)</u>	<u>\$ (2,176)</u>	<u>\$ (789)</u>

Losses on the guarantee asset decreased \$715 million, or 33 percent, to (\$1,461) million in 2003 compared to (\$2,176) million in 2002 primarily due to a smaller overall decline in mortgage interest rates which tends to directly affect actual and expected prepayments. Declining mortgage interest rates in 2002 and the first half of 2003 reduced the expected lives of the mortgages underlying outstanding PCs and the amount of estimated future guarantee fee cash flows.

Losses on guarantee assets increased to (\$2,176) million in 2002 from (\$789) million in 2001 mainly due to decreases in mortgage interest rates during 2002, which reduced the expected lives of the mortgages underlying outstanding PCs and the amount of estimated future guarantee fee cash flows.

Table 9 summarizes the 2003 and 2002 quarterly gains and losses on guarantee asset.

Table 9: Quarterly Gains (Losses) on Guarantee Asset

	<u>1Q 2003</u>	<u>2Q 2003</u>	<u>3Q 2003</u>	<u>4Q 2003</u>
	(dollars in millions)			
Gains (losses) on guarantee asset	\$ (568)	\$ (1,092)	\$ 258	\$ (59)

	<u>1Q 2002</u>	<u>2Q 2002</u>	<u>3Q 2002</u>	<u>4Q 2002</u>
	(dollars in millions)			
Gains (losses) on guarantee asset	\$ (213)	\$ (658)	\$ (890)	\$ (415)

In 2003 and 2002, quarterly fluctuations in gains and losses on guarantee asset were primarily attributable to changes in the expected lives of the mortgages underlying outstanding PCs, which were driven by changes in mortgage interest rates and expected prepayments.

Our guarantee asset primarily relates to our single-family portfolio. Through the first two quarters of 2003, our average single-family portfolio mortgage coupon rate was significantly higher than the prevailing average 30-year mortgage rate, increasing our expectation of prepayments and reducing the value of our guarantee asset. In the third quarter of 2003, mortgage interest rates increased slowing the pace of liquidations and increasing the value of the guarantee asset. Mortgage interest rates dropped slightly during the fourth quarter of 2003 which caused a small decline in the fair value of the guarantee asset. Mortgage interest rates dropped steadily throughout 2002 resulting in a reduction in the fair value of the guarantee asset in each quarter.

Income (Expense) on Guarantee Obligation

With the adoption of FIN 45 on January 1, 2003, we changed the way we account for “Income (expense) on ‘Guarantee obligation for Participation Certificates.’” For 2003, “Income (expense) on ‘Guarantee obligation for Participation Certificates’” represents a reduction of the guarantee obligation based on amortization using the actual prepayment experience on the underlying mortgage loans, which we refer to as the declining UPB method.

For 2002 and 2001, gains and losses on guarantee obligation represented the change in fair value of the obligation due to:

- *The portion of cash flow that is a reduction of the guarantee obligation; and*
- *Changes in the fair value of expected future cash outflows.*

Income (expense) on guarantee obligation was \$925 million, \$592 million and \$203 million in 2003, 2002 and 2001, respectively.

For all years presented in *Table 10* below, we established the guarantee obligations at their fair value, which are determined by estimating the amount and timing of cash flows related to the guarantee obligation. Factors in determining the fair value of the guarantee obligation include house price appreciation, interest rates, loan prepayment rates and other economic factors that influence expected credit losses and expected income earned on mortgage principal and interest payments held in our cash and investments portfolio pending remittance to the PC investors.

Table 10 summarizes the attribution of change to the guarantee obligation for 2003, 2002 and 2001. See “Table 18: Changes in Guarantee Obligation” in “Consolidated Balance Sheets Analysis – Guarantee Obligation for Participation Certificates” for additional information about the guarantee obligation.

Table 10: Attribution of Change – Guarantee Obligation

	<u>2003⁽¹⁾</u>	<u>2002</u>	<u>2001</u>
	<u>Amortization</u>	<u>Fair Value</u>	<u>Fair Value</u>
	(dollars in millions)		
Total cash flows paid	\$ -	\$ 422	\$ 278
Portion of cash flows paid related to imputed interest	-	(64)	(57)
Cash paid representing reduction of guarantee obligations	-	358	221
Changes in fair value of future cash flows	-	234	(18)
Amortization	925	-	-
Income (expense) on guarantee obligation	<u>\$ 925</u>	<u>\$ 592</u>	<u>\$ 203</u>

⁽¹⁾ As a result of the implementation of FIN 45 on January 1, 2003, we changed the method of recognizing income (expense) on guarantee obligation. See "Impact of New Accounting Standards or Changes in Accounting - Guarantor's Accounting."

In 2003, an increase in the balance of guarantee obligation, combined with a 63 percent liquidation rate on outstanding PCs and Structured Securities, resulted in \$925 million of income recognized on the amortization of our guarantee obligation.

Income on the guarantee obligation increased in 2002 compared with 2001 due to a number of factors affecting changes in the fair value of the guarantee obligation from period to period. The primary factor in the change in value during 2002 was the gains on the credit-related components of the guarantee obligation, partially offset by losses on the remittance cycle components of the guarantee obligation. Gains on the credit-related components of the guarantee obligation were driven by the general credit environment as well as changes in mortgage rates, which reduced the expected lives of the mortgages underlying outstanding PCs. Losses on the remittance cycle components of the guarantee obligation were driven by higher prepayment estimates combined with lower short-term

interest rates, which lowered the expected reinvestment yield and thereby increased the expected net expense associated with amounts due to PC investors.

Table 11 summarizes the 2003 and 2002 quarterly income (expense) on guarantee obligation.

Table 11: Quarterly Income (Expense) on Guarantee Obligation

	1Q 2003	2Q 2003	3Q 2003	4Q 2003
	(dollars in millions)			
Income (expense) on guarantee obligation	\$ 235	\$ 265	\$ 301	\$ 124
	1Q 2002	2Q 2002	3Q 2002	4Q 2002
	(dollars in millions)			
Income (expense) on guarantee obligation	\$ 146	\$ 156	\$ 62	\$ 228

During the first three quarters of 2003, the income on guarantee obligations increased as a result of two factors:

- The balance of our guarantee obligation increased throughout 2003 driven by the issuance of PCs through the Guarantor and MultiLender Programs during the year, and
- High liquidation rates for outstanding PCs reduced the UPB of the PCs, increasing the amortization of the liability into income under the declining UPB method.

The liquidation rate of outstanding PCs declined in the fourth quarter of 2003 due to generally higher rates during the second half of the year. As a result, the UPB of PCs did not decline as quickly as earlier in 2003, reducing the rate of amortization and the amount of income we recognized.

In 2002, changes in gains and losses on the guarantee obligation reported on a quarterly basis were primarily attributable to changes in the expected lives of the mortgages underlying outstanding PCs, which were driven by changes in mortgage interest rates. Fluctuations in the guarantee obligation were also driven by changes in short-term interest rates and in the credit environment, which also affect the value of future estimated cash flows.

Derivative Gains (Losses)

Derivative gains (losses) represent the change in fair value of derivatives not accounted for in a hedge accounting relationship since these transactions did not qualify for, or we did not elect to pursue, hedge accounting, resulting in fair value changes being recorded to earnings. Although derivatives are an important aspect of our management

of interest-rate risk, they may increase the volatility of reported net income, particularly when they are not accounted for in hedge accounting relationships.

We generally use interest-rate swaps to mitigate contractual funding mismatches between our assets and liabilities. A receive-fixed swap results in our receiving a fixed interest rate payment from our counterparty in exchange for a variable rate payment to the counterparty. Conversely, a pay-fixed swap requires us to make a fixed interest-rate payment in exchange for a variable rate payment. Call and put swaptions are options to enter into receive- and pay-fixed interest rate swaps, respectively. We use swaptions and other option-based derivatives to adjust the contractual funding of our debt in response to changes in the expected lives of assets in the retained portfolio. Mortgage borrowers generally have an option to prepay their mortgages prior to contractual maturity, and this prepayment option is sensitive to changes in interest rates.

Interest-rate swaps and swaptions that are not accounted for in hedge accounting relationships generally increase the volatility of reported net income since they are marked to fair value through earnings without the offsetting change in value of the economic hedged risk being recognized in earnings. The fair value of receive- and pay-fixed interest-rate swaps is primarily driven by changes in interest rates, with receive-fixed swaps increasing in value and pay-fixed swaps decreasing in value when interest rates decrease (and the opposite being true when interest rates increase). The fair value of purchased call and put swaptions is sensitive to changes in interest rates in a directionally similar manner to receive- and pay-fixed swaps, respectively. Swaption values are also driven by the market's expectation of potential changes in interest rates in the future (referred to as "implied volatility"), with swaptions generally being more valuable as implied volatility increases and less valuable as implied volatility decreases. Losses on options are limited to the premium paid to purchase the option plus any unrealized gains previously recorded.

Derivative gains (losses) totaled \$39 million, \$5,302 million and (\$2,313) million in 2003, 2002 and 2001, respectively. These gains and losses were primarily driven by changes in the fair value of certain interest-rate swaps and swaptions executed to manage interest-rate risk related to the retained portfolio as well as commitments to purchase or sell mortgages and mortgage-related securities. The decline in interest rates during the first half of 2003 followed by increases in the third and fourth quarters led to significant quarterly volatility. Net derivative gains of \$39 million were generated in 2003, as gains of \$2.8 billion on pay-fixed interest-rate swaps were offset by losses of (\$0.6) billion on call swaptions, losses of (\$0.3) billion on put swaptions, losses of (\$0.2) billion on receive-fixed swaps, (\$1.0) billion of costs related to periodic interest-rate swap settlements, and (\$0.7) billion of losses primarily attributed to commitments to purchase or sell mortgages and mortgage-related securities.

Derivative gains increased from 2001 to 2002 as interest rates declined and increased option volatility led to significant gains on our receive-fixed swaps and call swaptions, which were partially offset by losses on pay-fixed swaps and put swaptions.

The notional amounts and related gains and losses for our derivatives not accounted for in a hedge accounting relationships are described in *Table 12* below.

Table 12 provides a quarterly summary of the period-end notional amount and gains and losses related to swaps and swaptions used to manage interest-rate risk but not accounted for in hedge accounting relationships.

Table 12: Derivatives Not in Hedge Accounting Relationships

	1Q 2003		2Q 2003		3Q 2003		4Q 2003		2003	
	Notional	Gain (Loss)	Notional	Gain (Loss)	Notional	Gain (Loss)	Notional	Gain (Loss)	Notional	Gain (Loss)
	(dollars in billions)									
Call swaptions	\$ 153.4	\$ 0.3	\$ 167.8	\$ 3.1	\$ 173.8	\$ (3.1)	\$ 216.9	\$ (0.9)	\$ (0.6)	\$ (0.6)
Put swaptions	134.5	(0.3)	155.6	(0.3)	146.3	0.3	123.1	-	(0.3)	(0.3)
Receive-fixed swaps	52.7	0.2	24.2	0.6	31.6	(0.5)	13.9	(0.5)	(0.2)	(0.2)
Pay-fixed swaps	28.9	0.2	60.5	(0.4)	57.8	2.1	47.1	0.9	2.8	2.8
Subtotal		0.4		3.0		(1.2)		(0.5)	1.7	1.7
Accrual of periodic settlements		(0.1)		(0.2)		(0.4)		(0.3)	(1.0)	(1.0)
Other ⁽¹⁾		0.6		0.7		(1.5)		(0.5)	(0.7)	(0.7)
Total		\$ 0.9		\$ 3.5		\$ (3.1)		\$ (1.3)	\$ -	\$ -

	1Q 2002		2Q 2002		3Q 2002		4Q 2002		2002	
	Notional	Gain (Loss)	Notional	Gain (Loss)	Notional	Gain (Loss)	Notional	Gain (Loss)	Notional	Gain (Loss)
	(dollars in billions)									
Call swaptions	\$ 106.6	\$ (1.0)	\$ 129.0	\$ 1.7	\$ 120.9	\$ 5.3	\$ 131.4	\$ (0.6)	\$ 5.4	\$ 5.4
Put swaptions	91.4	(0.2)	88.4	(1.3)	73.3	(0.5)	129.9	(0.6)	(2.6)	(2.6)
Receive-fixed swaps	82.3	(0.4)	54.2	2.0	70.2	4.1	65.4	(0.1)	5.6	5.6
Pay-fixed swaps	63.4	0.9	49.2	(1.9)	55.3	(2.8)	43.4	0.3	(3.5)	(3.5)
Subtotal		(0.7)		0.5		6.1		(1.0)	4.9	4.9
Accrual of periodic settlements		(0.2)		(0.3)		(0.2)		(0.1)	(0.8)	(0.8)
Other ⁽¹⁾		(0.2)		0.4		0.4		0.6	1.2	1.2
Total		\$ (1.1)		\$ 0.6		\$ 6.3		\$ (0.5)	\$ 5.3	\$ 5.3

⁽¹⁾ Other consists of basis swaps, option-based contracts, futures, foreign-currency swaps, commitments, and other derivatives not accounted for in hedge relationships, including a prepayment management agreement and credit derivatives. See our Information Statement dated February 27, 2004 for further information.

Derivative gains (losses) fluctuated significantly during 2003 due to the decrease in interest rates during the first half of 2003 versus a rise in interest rates during the third quarter of 2003. During the second quarter of 2003, derivative gains of \$3.5 billion were primarily driven by a \$3.1 billion gain in the value of call swaptions, which was due to interest rate declines during the quarter. As interest rates increased during the third quarter of 2003, our call swaptions declined in value by (\$3.1) billion and we incurred

(\$1.4) billion of losses on commitments to purchase or sell mortgages and mortgage-related securities. These losses were partially offset by \$2.1 billion in gains on pay-fixed swaps. During 2002, derivative gains (losses) were largest in the third quarter when the gains totaled \$6.3 billion. This third quarter gain in 2002 was driven by a \$4.8 billion gain on call swaptions, net of losses on put swaptions, and a \$1.3 billion gain on receive-fixed swaps, net of losses on pay-fixed swaps. The decrease in interest rates in the third quarter of 2002 increased the fair value of the interest-rate swaps underlying the call swaptions, which combined with the increase in the implied volatility of interest rates, resulted in a significant increase in the value of the call swaptions. While increases in implied volatility also have a favorable effect on the value of put swaptions, the decrease in fair value of the underlying pay-fixed interest-rate swaps due to the decrease in interest rates resulted in a net decrease in the fair value of these swaptions during 2002.

Hedge Accounting Gains (Losses)

For those derivatives that are accounted for in a hedge accounting relationship, "Hedge accounting gains (losses)," or hedge accounting ineffectiveness, generally arises when the fair value change of a derivative financial instrument does not exactly offset the fair value change of the hedged item. Our hedge accounting relationships primarily consist of derivatives linked to either existing debt in a fair value hedge accounting relationship or the variability of interest payments on the forecasted issuances of debt securities in a cash flow hedge accounting relationship.

Hedge accounting gains were \$644 million in 2003, compared to hedge accounting gains of \$187 million in 2002 and hedge accounting losses of (\$294) million in 2001. Hedge ineffectiveness in these years related primarily to our fair value hedge accounting relationships. Hedge accounting gains (losses) will vary from period to period based on the notional amount of derivatives accounted for in hedge accounting relationships and the extent to which differences in the characteristics or terms of the derivative and the hedged item result in fair value or cash flow changes that are not exactly offset. For example, a significant portion of derivatives in our fair value hedges are forward starting and valued using forward rates while the hedged debt is valued using spot rates. Therefore the difference between the spot rate and the forward rate generally produces ineffectiveness in these fair value hedges, which is recognized in this caption.

Gains (Losses) on Investment Activity

Gains (losses) on investment activity include gains and losses on certain assets and liabilities marked to fair value through earnings. Also included are gains and losses related to sales, impairments and other valuation adjustments.

Table 13 summarizes the components of “Gains (losses) on investment activity.”

Table 13: Gains (Losses) on Investment Activity

	2003	2002	2001
	(dollars in millions)		
Gains (losses) on trading securities	\$ (2,130)	\$ 921	\$ 144
Gains (losses) on PCRs	(144)	(438)	(121)
Gains (losses) on sale of mortgage loans and available-for-sale securities	2,075	1,958	619
Security impairments	(736)	(650)	(350)
Mortgage LOCOM adjustments ⁽¹⁾	(179)	8	(101)
Total gains (losses) on investment activity	<u>\$ (1,114)</u>	<u>\$ 1,799</u>	<u>\$ 191</u>

⁽¹⁾ LOCOM refers to lower of cost or market value.

Gains (Losses) on Trading Securities were (\$2,130) million, \$921 million and \$144 million in 2003, 2002 and 2001, respectively. Gains (losses) on securities we hold that are classified for accounting purposes as trading represent changes in the fair value of our trading positions, which include trading securities held, certain forward commitments to purchase or sell trading securities, and Treasury and agency debt security “short sale” transactions (also referred to as “securities sold, not yet purchased”) executed for asset/liability management purposes. The trading positions consist of securities transactions executed in connection with our PC and mortgage-backed security market-making and support activities and certain securities held in the retained portfolio and in the cash and investments portfolio.

Entering 2003, our trading portfolio contained higher coupon mortgage-related securities that were in an unrealized gain position. The portfolio experienced losses because these higher coupon mortgage-related securities experienced significant prepayments during the first half of 2003 as interest rates fell. The interest earned on trading assets in the same period is included in net interest income. In addition, during the third and fourth quarters of 2003 the portfolio experienced losses as rising interest rates decreased the value of investments.

In 2002 trading gains were positively affected by the decline in interest rates during the year. In 2001, trading gains were negatively affected as we transferred approximately \$36 billion of securities to the trading category on January 1, 2001, in conjunction with the implementation of SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, resulting in an unrealized loss of approximately \$275 million being recorded to earnings.

Gains (Losses) on Participation Certificate Residuals, or PCRs, were (\$144) million, (\$438) million and (\$121) million in 2003, 2002 and 2001, respectively. A PCR represents the net fair value of any guarantee asset and guarantee obligation established with respect to a PC or Structured Security held by us. PCRs that are classified as trading

securities are marked to fair value as a component of “Gains (losses) on investment activity.” With the adoption of FIN 45 on January 1, 2003, our guarantee obligations are established at fair value and subsequently amortized. When we purchase a PC or Structured Security, the guarantee obligation is marked to fair value and netted against the related guarantee asset to create the PCR. On the date of purchase in conjunction with the establishment of the PCR, any difference between the amortized value of the guarantee obligation and its fair value is included as a component of gains (losses) on PCRs.

Net cash payments we receive on PCRs are reported in the income statement (primarily within net interest income as well as through components of non-interest expense that are credit and administrative related) and not as a direct reduction of the recorded PCR. In 2003, losses on PCRs decreased compared with 2002 due to a smaller overall decline in mortgage interest rates experienced during the year. In addition, the proportion of PCs and Structured Securities held by us that had a recognized PCR associated with them increased to 72 percent in 2003 from 38 percent in 2002 due to the adoption of FIN 45 together with an increase in the amount of retained portfolio purchase activity. Realization of cash flows and decreases in interest rates, which reduced the expected lives of the associated securities, accounted for the reported loss in 2002. In 2001, the loss was primarily due to the realization of cash flows.

Gains (Losses) on Sale of Mortgage Loans and Available-for-Sale Securities were \$2,075 million, \$1,958 million and \$619 million in 2003, 2002 and 2001, respectively. The increasing gains on the sale of mortgage loans and available-for-sale securities for 2003, 2002 and 2001 were primarily attributable to the increasing volume of sales of PCs and Structured Securities in all years, as well as the sales of Treasury and agency debt securities, originally purchased for asset/liability management purposes during 2003. In 2003, the increase in gains was also driven by an increase in the volume of transfers of PCs and Structured Securities that qualified as sales under SFAS 140 thereby triggering gains or losses based on differences in newly recognized guarantee assets and guarantee obligations.

Security Impairments were (\$736) million, (\$650) million and (\$350) million in 2003, 2002 and 2001, respectively. We record impairment losses on our investment portfolio when we have concluded that a decrease in the fair value of a security is other-than temporary. Impairment losses recognized in 2003, 2002 and 2001 were primarily related to certain investments in mortgage-related interest-only, or IO, securities and manufactured housing securities.

The primary source of impairment losses for the years presented was related to the mortgage-related IO securities. Impairment losses on mortgage-related IO securities totaled (\$524) million, (\$568) million and (\$325) million in 2003, 2002 and 2001, respectively. Emerging Issues Task Force, or EITF, 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*, or EITF 99-20, was implemented in the second quarter of 2001 when it became effective. EITF 99-20 requires the cost basis of a mortgage-related IO security to

be written down to fair value when there is both a decline in fair value below the carrying amount and an adverse change in expected cash flows. See “Cumulative Effect of Change in Accounting Principles, Net of Taxes” below for more information on the cumulative effect to net income from the adoption of EITF 99-20.

Decreasing interest rates result in a decrease in expected cash flows from mortgage-related IO securities and a corresponding decrease in the fair value of these securities. During the first half of 2003, interest rates continued to decline from 2002 levels resulting in an increase in prepayments and, in turn, a higher level of impairment losses than in the prior year. In 2003, interest rates decreased sharply during the first and second quarters; as a result, 86 percent of the 2003 mortgage-related IO securities impairment losses were recognized in those quarters. As interest rates began to rise in the third and fourth quarters of 2003, impairment losses recognized were greatly reduced. The increase in mortgage-related IO security impairment losses during 2002 relates to the decline in interest rates as compared to 2001.

Impairments recorded on non-IO securities totaled (\$212) million, (\$82) million and (\$25) million in 2003, 2002 and 2001, respectively, with impairments on manufactured housing securities totaling (\$208) million, (\$67) million and (\$23) million during the same periods. We recognize an impairment if the decrease in fair value of a security below its carrying value is determined to be other than temporary. More specifically, we recognize an impairment when a security fails one or more of a series of “bright line” tests relative to its fair value compared to its book value, credit ratings or the amount of time the investment has been in an unrealized loss position, or if management otherwise believes that an unrealized loss is other than temporary. Impairment losses on manufactured housing securities exclude the effects of financial guarantee contracts since the benefits of such contracts are not recognized until claims become probable of recovery under the contracts.

Mortgage LOCOM Adjustments were (\$179) million, \$8 million and (\$101) million in 2003, 2002 and 2001, respectively. We record mortgage loans classified as “held-for-sale” in accordance with SFAS 65, *Accounting for Certain Mortgage Banking Activities*, at the lower of amortized cost or market value, or LOCOM, with changes in the valuation of our held-for-sale portfolio recorded to this caption.

Losses related to loans held in the retained portfolio are recorded as a reduction to the cost basis in the retained portfolio assets and are amortized into income over the estimated life of the assets as part of net interest income.

Mortgage LOCOM losses were primarily recognized in the third quarter of 2003, totaling (\$178) million. The sharp decline in mortgage interest rates in the second quarter of 2003 resulted in an increase in mortgages purchased as the market experienced heavy refinancing activity. A sharp increase in mortgage interest rates during the third quarter of 2003 reduced the value of our held-for-sale mortgage loan portfolio resulting in LOCOM adjustments.

Gains (Losses) on Debt Retirement

We record gains and losses on debt repurchases that are accounted for as extinguishments of debt based on the difference between the contractual interest rates on the debt securities repurchased (adjusted for deferred premiums, discounts, and hedging gains and losses) and current market interest rates, and the write-off of related deferred debt issuance costs. To the extent we issue new debt securities to replace the debt that we retire, the difference in the debt costs will positively or negatively affect net interest income to be reported in future periods.

We incurred losses of (\$1,775) million, (\$674) million and (\$356) million on the repurchase of approximately \$27 billion, \$20 billion and \$5 billion in principal amount of debt outstanding in 2003, 2002 and 2001, respectively. The most significant debt repurchases in 2003 occurred in the second quarter when we repurchased an aggregate of approximately \$17 billion of U.S. dollar and Euro-denominated debt securities, most of which followed the announcement of changes in our senior management. We executed these particular repurchases in an effort to support the liquidity and price performance of these securities. Of the (\$1,775) million of losses incurred in 2003, (\$1,266) million was incurred in the second quarter. Where we have designated derivatives as hedges of issued debt securities, we recognize any deferred hedging gains or losses upon the retirement of that debt.

Resecuritization Fees

Resecuritization fees are revenues we earn primarily in connection with the creation of Structured Securities with underlying collateral provided by third parties for which a Real Estate Mortgage Investment Conduit, or REMIC, election was made by Freddie Mac. These fees are also generated in connection with the creation of IO and principal-only, or PO, strips as well as other Structured Securities.

Resecuritization fees totaled \$352 million, \$276 million and \$135 million in 2003, 2002 and 2001, respectively. Investors' demand for Structured Securities increased significantly in all three years largely due to the steepening of the yield curve during these periods. A steep yield curve generally increases the value of structured cash flows, which results in greater value differences between PCs and Structured Securities.

Other Income and Certain Prior Year Accounting Error Adjustments

Other income primarily consists of fees associated with servicing and technology-related programs, including Loan Prospector®, various fees related to multifamily loans (including application and other fees) and various other fees received from mortgage originators and servicers. In 2003, other income also includes the correction of certain immaterial prior year accounting errors.

“Other income” totaled \$493 million, \$321 million and \$229 million in 2003, 2002 and 2001, respectively. As discussed in our earnings release dated June 30, 2004, in the process of reviewing our accounting policies and practices for 2003, we identified

certain immaterial errors that resulted in the cumulative net understatement of income of approximately \$214 million (\$139 million after-tax). An adjustment to correct this understatement was recorded in the first quarter of 2003. This adjustment includes approximately \$271 million of income recorded to correct the accounting for certain swaption transactions that were physically settled (i.e., by actually entering into the underlying swap) during 2002, but for which the value of the underlying swap on the settlement date was not correctly recorded, and approximately \$27 million of income related to the recognition of loan prepayment fees earned in 2002, but recorded in 2003. These corrections were partially offset by a (\$26) million reduction of income to correct for errors in the calculation of the change in fair value of the hedged risk within certain hedges of foreign denominated debt and a (\$58) million reduction in income to correct the equity-method earnings that were recorded on certain low income housing tax credit partnerships based on the use of tax-based financial statements when GAAP-basis financial statements were available. The increase in this category during 2002 is primarily due to an increase in servicing and transaction fees resulting from increased business volumes and use of our automated underwriting tools by third parties.

NON-INTEREST EXPENSE

Credit-Related Expenses

Credit-related expenses include the “Provision for credit losses” and “REO operations income (expense).” The “Provision for credit losses” includes provisions for losses incurred on mortgage loans held in the retained portfolio that are held for investment and outstanding PCs and that portion of Structured Securities held by third parties that are backed by non-agency mortgage-related securities. In 2002 and prior years, a portion of the recognized guarantee obligation was attributable to estimated incurred losses on outstanding PCs and Structured Securities. “REO operations income (expense)” includes certain costs associated with the acquisition of real estate at the time of foreclosure, gains and losses on the sale of foreclosed properties we hold, as well as the cost to hold these properties, including real estate taxes, insurance, repairs and fees incurred to prepare the properties for sale, and provision for valuation losses occurring between acquisition and disposition.

Table 14 summarizes the components of credit-related expenses (expenses are presented as bracketed amounts in this table).

Table 14: Credit-Related Expenses

	2003	2002	2001
	(dollars in millions)		
Provision for credit losses	\$ (10)	\$ (128)	\$ (32)
REO operations income (expense)	23	13	(7)
Total credit-related expenses	<u>\$ 13</u>	<u>\$ (115)</u>	<u>\$ (39)</u>

The provision for credit losses may be expense or income, depending on whether the loan loss reserve balances need to be increased or decreased at any given period end.

Total credit-related expenses decreased by \$128 million in 2003, compared to an increase of \$76 million in 2002. The provision for credit losses was (\$10) million for 2003, compared to (\$128) million for 2002 and (\$32) million for 2001. Management establishes the credit loss reserve based on its periodic assessment of estimated incurred losses. The provision for credit losses was lower in 2003 than 2002 primarily due to the 2002 provision reflecting an increase in expected losses on multifamily mortgage loans driven by higher vacancy rates and a decrease in net operating income of multifamily properties in certain markets.

The increase in total credit-related expenses in 2002 primarily reflects an increase in estimated incurred losses on multifamily mortgage loans due to higher vacancy rates and a decrease in net operating income of multifamily properties in certain areas. The increase in 2002 in “Provision for credit losses” was partially offset by an increase in income from operations related to real estate owned, or REO.

Administrative Expenses and Other Expenses

Salaries and employee benefits, professional fees, occupancy expense and certain other expenses are collectively referred to as administrative expenses. These costs are generally incurred to conduct daily operations although in certain cases, costs related to charitable contributions and specific transactions or events are included in this category.

Table 15 summarizes administrative and other expenses (expenses are presented as bracketed amounts in this table).

Table 15: Administrative Expenses and Other Expenses

	2003	2002	2001
	(dollars in millions)		
Salaries and employee benefits	\$ (624)	\$ (593)	\$ (537)
Professional services	(254)	(146)	(145)
Occupancy expense	(52)	(42)	(35)
Other administrative expenses	(324)	(227)	(199)
Total administrative expenses	(1,254)	(1,008)	(916)
Charitable contributions	(6)	(260)	(32)
Amortization of credit enhancements	(134)	-	-
OFHEO civil money penalty	(125)	-	-
Selected affordable housing transaction fees	(124)	-	-
Loan Prospector [®] -related expenses	(99)	(86)	(76)
Realized losses on certain guarantees	(60)	-	-
Disposition of certain technology-related assets	-	(52)	-
Total administrative and other expenses	<u>\$ (1,802)</u>	<u>\$ (1,406)</u>	<u>\$ (1,024)</u>

Total administrative expenses and other expenses were (\$1,802) million, (\$1,406) million and (\$1,024) million in 2003, 2002 and 2001, respectively. As shown in Table 15 above, administrative expenses totaled (\$1,254) million, (\$1,008) million and (\$916) million in 2003, 2002 and 2001, respectively. The increase in administrative expenses

for 2003 was primarily driven by additional accounting, auditing and consulting costs of approximately (\$124) million and legal costs of approximately (\$48) million associated with the restatement and remediation activities in 2003. The (\$124) million is comprised of approximately (\$56) million of added professional services expenses, (\$15) million of added compensation costs and (\$53) million of other costs, principally related to increased audit fees. Salaries and benefits also increased in each year as we increased the number of employees and increased salaries.

Expenses were also higher in 2003 as we paid a (\$125) million civil money penalty in connection with OFHEO's investigation. Additionally, during the third and fourth quarters of 2003, we entered into certain affordable housing transactions that contained a number of contractual incentives, including the payment of fees totaling (\$124) million. Furthermore, we began recognizing amortization of credit enhancements and realized losses related to certain guarantees in "Other expenses" in 2003 which totaled (\$194) million.

Total charitable contributions for 2002 were (\$260) million, including a special (\$225) million cash contribution to the Freddie Mac Foundation and corporate giving programs announced in the fourth quarter. The contribution to the Freddie Mac Foundation is expected to provide operating funds for the Foundation for six to eight years. In 2002, "Other expenses" also included a (\$52) million loss recognized in the fourth quarter of 2002 related to the disposition of certain technology-related assets.

Housing Tax Credit Partnerships

Housing tax credit partnerships represent our share of the net operating losses generated from investments in partnerships that develop or rehabilitate low-income multifamily rental properties. Although these partnerships generate operating losses, we realize a return on our investment through reductions in "Income tax expense," which result from tax credits and the deductibility of the operating losses.

Our share of net operating losses generated from our investment in "Housing tax credit partnerships" totaled (\$200) million, (\$160) million and (\$121) million in 2003, 2002 and 2001, respectively. The year-over-year increases in this expense primarily reflect our increased investment in such partnerships. The related tax benefits, which are reported as a reduction in "Income tax expense," totaled \$302 million, \$220 million and \$172 million in 2003, 2002 and 2001, respectively.

Minority Interest in Earnings of Consolidated Subsidiaries

Minority interest in earnings of consolidated subsidiaries represents the earnings due to third party investors in our consolidated subsidiaries.

Minority interest in earnings of consolidated subsidiaries totaled (\$157) million, (\$184) million and (\$208) million in 2003, 2002 and 2001, respectively. The majority of this amount for each of 2003, 2002 and 2001 relates to dividends on the preferred stock

issued by our two majority-owned real estate investment trust, or REIT, subsidiaries. These amounts will continue to decrease as the recorded amount of the REITs' preferred stock declines over time. Under the terms of the preferred stock, the dividend rate will decline to one percent in 2007.

INCOME TAX EXPENSE

Income tax expense includes (i) deferred tax expense, which represents the net change in the deferred tax asset or liability balance during the year plus any change in a valuation allowance, and (ii) current tax expense, which represents the amount of tax currently payable to or receivable from a tax authority plus amounts accrued for expected tax deficiencies (including both tax and interest).

Income tax expense was (\$2,202) million, (\$4,713) million and (\$1,339) million in 2003, 2002 and 2001, respectively. The effective tax rates for 2003, 2002 and 2001 were 31.0 percent, 31.8 percent and 30.1 percent, respectively. The decrease in the effective tax rate from 2002 to 2003 was due to lower growth in pre-tax income in relation to tax credits and interest income on tax-exempt securities. These effects were partially offset by a non-tax deductible (\$125) million OFHEO civil money penalty recorded in the fourth quarter of 2003 and a decrease to the tax reserve related to favorable U.S. Tax Court rulings recorded in the fourth quarter of 2002.

CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLES, NET OF TAXES

Cumulative effect of change in accounting principles includes the effects of adopting SFAS 133 on January 1, 2001 and EITF 99-20 on April 1, 2001.

The after-tax adjustments required by SFAS 133 resulted in a \$78 million increase in net income for the first quarter of 2001. The cumulative effect on earnings from the change in accounting principle is primarily attributable to an after-tax gain of \$52 million resulting from recording certain options at their fair value and an after-tax gain of \$26 million due to cumulative accounting ineffectiveness on hedge accounting relationships involving receive-fixed swaps previously accounted for under accrual accounting. The adoption of EITF 99-20 resulted in a \$35 million decrease to net income in the second quarter of 2001. This after-tax adjustment was related to impairment losses required under EITF 99-20 on certain IO securities held at April 1, 2001.

Consolidated Balance Sheets Analysis

Table 16 provides summary balance sheets as of December 31, 2003 and 2002. This table should be viewed in conjunction with the complete Consolidated Balance Sheets.

Table 16: Summary Balance Sheets

	As of December 31,	
	2003	2002
	<i>(dollars in millions)</i>	
Retained portfolio	\$ 660,357	\$ 589,722
Cash and investments	109,078	135,037
Guarantee asset for Participation Certificates, at fair value	3,686	2,445
Derivative assets, at fair value	16,180	10,393
Other items included in total assets	14,148	14,652
Total assets	<u>\$ 803,449</u>	<u>\$ 752,249</u>
Total debt securities, net	\$ 739,613	\$ 665,696
Due to Participation Certificate investors	13,205	35,080
Guarantee obligation for Participation Certificates	2,904	1,427
Derivative liabilities, at fair value	357	967
Other items included in total liabilities	13,879	15,440
Total liabilities	<u>769,958</u>	<u>718,610</u>
Minority interest in consolidated subsidiaries	1,929	2,309
Total stockholders' equity	<u>31,562</u>	<u>31,330</u>
Total liabilities and stockholders' equity	<u>\$ 803,449</u>	<u>\$ 752,249</u>

During 2003, our total assets grew \$51.2 billion, or 7 percent. This increase was driven by increases in the retained portfolio partially offset by decreases in cash and investments. During the same period, total liabilities, plus minority interest in consolidated subsidiaries, increased by \$51.0 billion, which was driven by increases in total debt securities partially offset by decreases in the amount due to PC investors. These and other changes in our Consolidated Balance Sheets are discussed below.

RETAINED PORTFOLIO

The retained portfolio includes mortgage loans and mortgage-related securities that we acquire for investment purposes and primarily consists of Freddie Mac and other agency securities.

The retained portfolio increased by \$70.6 billion, or 12 percent, to \$660.4 billion in 2003 from \$589.7 billion in 2002 with the largest growth occurring in the third quarter of 2003. The retained portfolio UPB (which excludes premiums, discounts, deferred fees and other basis adjustments, the reserve for losses on mortgages held for investment, unrealized gains or losses on mortgage-related securities and PCRs) increased 14 percent during 2003. We generally increase our mortgage-related investment activity when

market conditions provide investment returns that exceed threshold levels. Such opportunities are more likely to be available when there is less competition for mortgage-related investments from other investors. Interest rates were extremely low through the first half of 2003 resulting in the lowest mortgage rates seen in the last 45 years. These low rates created a large wave of refinancing activity in the mortgage industry, leading to significant liquidations of mortgage-related securities held in the portfolio. Despite these liquidations, there was an increase in mortgage-related security supply due to refinancing activity and new purchase money activity. The increase in supply coupled with opportunities to retain selected cash flows on structured securitizations generated strong portfolio growth, especially in the third quarter as residential real estate closings hit record highs.

CASH AND INVESTMENTS

Cash and investments includes investments we acquire to manage recurring cash flows, provide a source of liquidity, temporarily deploy capital until the capital can be redeployed into retained portfolio investments and manage interest-rate risk exposure. Cash and investments also include certain mortgage-related securities that are not included in the retained portfolio since they are acquired in conjunction with our PC market-making and support activities.

Our cash and investments portfolio decreased by \$26.0 billion, or 19 percent, to \$109.1 billion in 2003 from \$135.0 billion in 2002 primarily due to the liquidation of Treasury securities held in the portfolio during the first quarter of 2003 after we determined that these transactions did not qualify as derivatives under GAAP as discussed in our Information Statement dated February 27, 2004. Accordingly, during 2003, we stopped using such securities to manage our interest-rate risk. Additionally, over the course of 2003, we reduced the amount of non-mortgage related asset-backed securities and corporate debt securities we hold while increasing our cash and cash equivalents balances.

GUARANTEE ASSET FOR PARTICIPATION CERTIFICATES

The “Guarantee Asset for Participation Certificates” represents the fair value of future cash inflows related to PC guarantees issued by us in transactions that qualify as sales or were subject to the requirements of FIN 45.

The guarantee asset increased by \$1.2 billion, or 51 percent, to \$3.7 billion in 2003 from \$2.4 billion in 2002. The changes in the guarantee asset balances during 2003 and 2002 are summarized in *Table 17*.

Table 17: Changes in Guarantee Asset

	<u>2003</u>	<u>2002</u>
	(dollars in millions)	
Beginning Balance	\$ 2,445	\$ 3,156
Adjustment for change in accounting ⁽¹⁾	(121)	-
Additions, net	2,823	1,465
Changes in fair value	<u>(1,461)</u>	<u>(2,176)</u>
Ending balance	<u>\$ 3,686</u>	<u>\$ 2,445</u>

⁽¹⁾ As of January 1, 2003, the fair value of those credit enhancements that were previously recognized as a component of guarantee assets were reclassified to other assets.

The increase in net additions to the guarantee asset in 2003 compared to 2002 was primarily due to the adoption of FIN 45, which requires the recognition of a guarantee asset for all new guarantees issued through our Guarantor Program. For additional information about the adoption of FIN 45 see “Impact of New Accounting Standards or Changes in Accounting – Guarantor’s Accounting.” “Additions, net” now includes the fair value of the guarantee assets related to both new PCs created through the Guarantor Program as well as for a portion of those PCs issued through other similar transactions, and PCs and Structured Securities that qualified as sales. The guarantee asset is presented net of reductions attributable to purchases of guaranteed securities. Purchases result in a reduction of the associated guarantee asset and re-establishment of those amounts as PCRs.

In 2002, additions include the fair value of the guarantee asset related solely to PCs and Structured Securities sold subject to SFAS 140 during the period, net of reductions attributable to purchases of these securities.

GUARANTEE OBLIGATION FOR PARTICIPATION CERTIFICATES

The “Guarantee Obligation for Participation Certificates” increased by \$1.5 billion to \$2.9 billion in 2003 from \$1.4 billion in 2002. The changes in the guarantee obligation balances during 2003 and 2002 are summarized in *Table 18*.

Table 18: Changes in Guarantee Obligation

	2003	2002
	(dollars in millions)	
Beginning balance	\$ 1,427	\$ 1,155
Adjustment for change in accounting ⁽¹⁾	(110)	-
Additions, net		
Fair value of newly-issued guarantee obligations ⁽²⁾	1,665	864
Deferred gains on newly-executed guarantees ⁽³⁾	847	-
Amortization of obligations and deferred gains ⁽⁴⁾	(925)	-
Change in fair value	-	(592)
Ending balance	<u>\$ 2,904</u>	<u>\$ 1,427</u>

⁽¹⁾ On January 1, 2003, that portion of recognized guarantee obligations that was attributable to estimated incurred losses on outstanding PCs, or \$110 million, was reclassified to “Reserve for guarantee losses on Participation Certificates.”

⁽²⁾ Includes the fair value of guarantee obligations that were recognized in connection with transfers of PCs and Structured Securities in 2003 that qualified as sales, as well as the fair value of guarantee obligations recognized in 2003 that related to PCs and Structured Securities that were issued in Guarantor swaps and other similar transactions whose settlements were subject to FIN 45.

⁽³⁾ Represents the excess of recognized guarantee assets and other assets (that relate to recognized credit enhancements) over recognized guarantee obligations that is deferred as a component of recognized guarantee obligations. Such deferred amounts are adjusted for buy-downs and credit fees received on Guarantor swaps and other similar transactions. Negative differences between such assets and liabilities are immediately recognized in earnings.

⁽⁴⁾ Effective January 1, 2003, recognized guarantee obligations were no longer subsequently measured on a fair value basis through earnings. Rather, we began to amortize such liabilities into earnings on a declining UPB basis.

- The increase in the guarantee obligation to \$2.9 billion in 2003 from \$1.4 billion in 2002 was primarily due to the adoption of FIN 45. For additional information about the adoption of FIN 45 see “Impact of New Accounting Standards or Changes in Accounting – Guarantor’s Accounting.” In 2003, additions to the guarantee obligation include the fair value of guarantee obligations established on new PCs created through the Guarantor Program and other similar transactions, as well as PCs and Structured Securities that qualified as sales. The guarantee obligation also includes the fair value of gains deferred at inception on new Guarantor transactions.

The guarantee obligations are presented net of reductions attributable to purchases of PCs or Structured Securities. Purchases result in a reduction of the associated guarantee obligations and re-establishment of those amounts as a component of the related PCRs. The fair value of gains are also presented net of reductions attributable to purchases of PCs or Structured Securities. Purchases also result in a reduction of fair

value gains in guarantee obligations and a corresponding adjustment to the cost basis of the purchased security.

In 2002, additions include the fair value of the obligation related solely to PCs and Structured Securities sold subject to SFAS 140 during the period, net of reductions attributable to purchases of guaranteed securities.

Factors contributing to the change in the fair value and amortization of the guarantee asset and guarantee obligation are discussed in “Results of Operations – Non-Interest Income – *Gains (Losses) on Guarantee Asset and Income (Expense) on Guarantee Obligation.*”

DERIVATIVE ASSETS AND LIABILITIES, AT FAIR VALUE

All derivatives are reported at fair value with changes in fair value of derivatives accounted for in hedge accounting relationships recorded to Accumulated Other Comprehensive Income or “Hedge accounting gains (losses).” Changes in fair value of derivatives not accounted for in hedge accounting relationships are recorded to “Derivative gains (losses).” We use derivatives to manage our interest-rate risk exposure. However, hedge accounting has not been applied to many derivative transactions since a significant number of transactions did not meet hedge accounting requirements or we elected not to pursue hedge accounting.

During 2003, the balance of derivatives in a gain position (reported as “Derivative assets, at fair value”) increased by \$5.8 billion, or 56 percent, to \$16.2 billion in 2003 from \$10.4 billion in 2002, while the balance of derivatives in a loss position (reported as “Derivative liabilities, at fair value”) decreased by \$0.6 billion, or 63 percent, to \$0.4 billion in 2003 from \$1.0 billion in 2002. Derivative assets and liabilities are presented on the consolidated balance sheets at their fair values, which are affected by changes in market conditions such as interest rates. The change in the carrying amount of these derivative assets and liabilities from period to period includes the changes in their fair values, which are recorded either in current income or AOCI, and the effect of the purchase, sale or termination of any derivative contracts during the period. During 2003, pay-fixed swaps and foreign currency swaps increased in fair value by approximately \$9.3 billion and \$3.4 billion, respectively, partially offset by a decrease in fair value of receive-fixed swaps of \$5.1 billion. The increase in the value of pay-fixed swaps was driven by the increase in interest rates during the latter part of 2003. The increase in the value of foreign currency swaps was primarily driven by the increase in the Euro exchange rate against the U.S. dollar during 2003.

TOTAL DEBT SECURITIES, NET

We issue non-callable and callable short- and long-term debt securities in domestic and global capital markets in a wide range of maturities to meet our funding needs. The balance of debt securities includes deferred premiums, discounts and hedging gains and losses.

Total debt securities increased by \$73.9 billion, or 11 percent, to \$739.6 billion in 2003 from \$665.7 billion in 2002. This increase corresponds to the increase in the retained portfolio as discussed above. During 2003, debt due within one year increased by \$50.8 billion, while debt due after one year increased by \$23.1 billion. As a result of declining interest rates in the first half of 2003, the expected lives of assets held in the retained portfolio decreased, reducing the need for long-term debt. To shorten the effective weighted average lives of our debt and thereby manage the funding mismatch created by the decline in interest rates, we issued additional short-term debt, extinguished long-term debt by calling and repurchasing debt and further shortened the duration of our debt by terminating pay-fixed swaps and entering into receive-fixed swaps.

DUE TO PARTICIPATION CERTIFICATE INVESTORS

Timing differences between our receipt of principal and interest payments from mortgage servicers and the subsequent pass through to PC investors result in the liability "Due to Participation Certificate investors."

Amounts due to PC investors decreased by \$21.9 billion, or 62 percent, to \$13.2 billion in 2003 from \$35.1 billion in 2002. This decrease was due to the increase in interest rates during the second half of 2003, which resulted in decreased mortgage prepayments at year-end 2003 compared to year-end 2002. The liquidation rate on total PCs issued and Structured Securities, including PCs we hold, also declined to 30 percent (annualized) in the fourth quarter of 2003, down significantly from the fourth quarter of 2002.

TOTAL STOCKHOLDERS' EQUITY

Total stockholders' equity increased by \$0.2 billion to \$31.6 billion in 2003 from \$31.3 billion in 2002. *Table 19* summarizes the components of stockholders' equity.

Table 19: Total Stockholders' Equity

	2003	2002
	(dollars in millions)	
Preferred stock	\$ 4,609	\$ 4,609
Common stock	152	152
Additional paid-in capital	814	744
Retained earnings	28,912	24,955
Accumulated other comprehensive income (loss), net of taxes, related to:		
Available-for-sale securities	6,349	12,217
Cash flow hedge relationships	(7,837)	(9,877)
Minimum pension liability	(10)	-
Treasury stock	(1,427)	(1,470)
Total stockholders' equity	<u>\$ 31,562</u>	<u>\$ 31,330</u>

The primary drivers of the increase in total stockholders' equity for 2003 were an increase in retained earnings and lower deferred losses on cash flow hedge accounting relationships included in AOCI offset by losses in AOCI related to "Available-for-sale securities." Generally, the fair value of the available-for-sale portfolio would be expected to move inversely to long-term interest rates. However, despite the decline in interest rates during the first and second quarters of 2003, the available-for-sale portfolio declined in value during 2003. The decline in value within the available-for-sale portfolio was driven by the high prepayments experienced at the beginning of 2003 when interest rates were lower. The rise in interest rates during the third and fourth quarters of 2003 also contributed to the overall decline in value for 2003.

Impact of New Accounting Standards or Changes in Accounting

Derivative Instruments and Hedging Activities

Effective July 1, 2003, we adopted SFAS 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, or SFAS 149. SFAS 149 amended and clarified the financial accounting and reporting for derivative instruments to incorporate decisions made by the FASB and the FASB's Derivative Implementation Group subsequent to the original issuance of SFAS 133 and in connection with other FASB projects. Under SFAS 149, purchase commitments for certain loans to be classified as held for investment must be accounted for as derivatives. The implementation of SFAS 149 did not have a material effect on the consolidated financial statements.

Non-Hedging Derivatives

In September 2003, the Office of the Chief Accountant of the SEC presented its view regarding the income statement presentation of non-hedging derivatives to the American Institute of Certified Public Accountants' SEC Regulations Committee. To be consistent with the SEC guidance published at that time, we are reporting the income statement effects of derivatives not currently designated in hedge accounting relationships under SFAS 133 in a single line item on our Consolidated Statements of Income, "Derivative gains (losses)," for all periods presented. Prior to 2003, the accrual for periodic cash settlements in accordance with the contractual terms of derivatives not in hedge accounting relationships was recorded in net interest income as a component of "Income (expense) related to derivatives." Therefore, for all periods presented, the impact of the accrual for these periodic derivative cash settlements has been reclassified from "Income (expense) related to derivatives" to "Derivative gains (losses)." The effect of this reclassification on our Consolidated Statements of Income was to increase "Net interest income" by \$1,040 million, \$639 million and \$456 million for 2003, 2002 and 2001, respectively, and decrease "Non-interest income" by the same amounts.

Consolidation of Variable Interest Entities

In January 2003, the FASB issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, or FIN 46. FIN 46 provides guidance for determining when a company must consolidate the assets, liabilities and activities of a variable interest entity, or VIE. A VIE is an entity (i) that has a total equity investment at risk that is not sufficient to finance its activities without additional subordinated financial support from other entities, or (ii) where the group of equity holders does not have the ability to make significant decisions about the entity's activities, or the obligation to absorb the entity's expected losses or the right to receive the entity's expected residual return, or both. In December 2003, the FASB released a revision of FIN 46, or FIN 46-R. The revision captured much of the guidance to date that had been provided by the FASB for implementation of the Interpretation, clarified certain portions of the original Interpretation and revised certain effective dates for implementation. We adopted FIN 46-R for 2003 year-end reporting. The implementation had no effect on our consolidated financial statements.

Guarantor's Accounting

Effective January 1, 2003, we adopted FIN 45, and FASB Staff Position 45-2, *Whether FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others," Provides Support for Subsequently Accounting for a Guarantor's Liability at Fair Value*, or FSP 45-2. FIN 45 requires companies to recognize a liability at the inception of a guarantee representing the fair value of the obligation undertaken in issuing the guarantee. FSP 45-2 changed the way we account for our guarantee obligations beginning on January 1, 2003. Specifically, the fair value of the guarantee obligation recorded at initial sale or securitization of mortgage-related assets, which is reflected in

“Guarantee obligation for Participation Certificates” on our Consolidated Balance Sheets, is subsequently amortized into earnings through “Income (expense) on ‘Guarantee obligation for Participation Certificates’” on our Consolidated Statements of Income. This amortization for each security is based on the actual prepayment experience of the collateral underlying the security. Changes in fair value are no longer recorded in earnings through “Income (expense) on ‘Guarantee obligation for Participation Certificates’” on our Consolidated Statements of Income. We applied the above guidance to new guarantees issued or modified after December 31, 2002, as well as to existing guarantees on a prospective basis, which were previously recognized at fair value as of December 31, 2002.

The implementation of FIN 45 and other accounting changes in 2003 had a significant impact on our accounting for the guarantee assets and guarantee obligations recognized with respect to our issuance and purchase of Participation Certificates, or PCs, and other related activities. These accounting changes are reflected in our method of reporting these activities and the composition of various line items on our Consolidated Statements of Income and Consolidated Balance Sheets as described below.

Guarantee Asset and Guarantee Obligation

As of December 31, 2002, the “Guarantee Asset for Participation Certificates” and the “Guarantee Obligation for Participation Certificates” represented the fair value of future cash flows related solely to PC guarantees issued by us in transactions that qualified as sales. As of December 31, 2003, the guarantee asset includes guarantees established at fair value on all new PCs issued through the Guarantor Program. On January 1, 2003, the portion of the guarantee asset related to credit enhancements was reclassified to “Other assets” and is being amortized to “Other expenses” based upon the related declining mortgage balance or the expiration of the credit enhancements, whichever is shorter.

Beginning on January 1, 2003, guarantee obligations are also established at fair value for new PCs issued through our Guarantor Program. In addition, for PCs issued through our Guarantor Program, the excess of recognized guarantee assets and other assets (that relate to recognized credit enhancements) over recognized guarantee obligations is deferred as a component of recognized guarantee obligations. Such deferred amounts are adjusted for buy-downs and credit fees received on Guarantor swaps and other similar transactions. Negative differences between such assets and liabilities are immediately recognized in earnings. During 2003, all net additions to the guarantee obligation from PC issuances continued to be established at fair value and all other period changes to the guarantee obligation were recognized through amortization using the actual prepayment experience on the underlying mortgage loans. As a result, the balance of the guarantee obligation as of December 31, 2003 represents the remaining unamortized balance of the guarantee obligations, which were originally established at fair value.

RECENT EVENTS AND CONTINGENCIES

The information presented below updates and supplements certain information discussed in the “Subsequent Events” section of our Information Statement dated February 27, 2004 and in our Information Statement Supplements issued since that date. Readers should therefore read the information presented below in conjunction with the “Subsequent Events” section of our Information Statement dated February 27, 2004, as well as the Information Statement Supplements issued since that date, to obtain a more complete understanding of our recent events and contingencies.

Legal Proceedings

Class Action Lawsuits. As previously disclosed, on January 15, 2004, the plaintiffs in the securities class action in the Southern District of Ohio filed an amended complaint, incorporating information disclosed in Freddie Mac's restatement. The basis of the claims remained essentially the same, although the class period alleged now ranges from July 15, 1999 to June 6, 2003. On April 1, 2004, Freddie Mac moved to dismiss the Complaint. The motion currently is scheduled to be heard on July 19, 2004. The case is stayed pending a determination of the motion.

By Stipulated Order dated March 15, 2004, the Ohio Public Employees Retirement System (“OPERS”) and the State Teachers Retirement System of Ohio (“STRS”) were appointed lead plaintiffs for the securities class actions. All but one of the securities class actions filed in the Southern District of New York and the Eastern District of Virginia during June, July and August 2003 have been voluntarily dismissed without prejudice by the plaintiffs. The remaining action has been consolidated with the lawsuit filed by OPERS and STRS, which has been transferred to the U.S. District Court for the Southern District of New York.

Shareholder Derivative Lawsuits. On January 16, 2004, Freddie Mac moved to dismiss all of the allegations of the July 1, 2003 lawsuit for failure to make a pre-suit demand. The motion is pending. With regard to the December 11, 2003 lawsuit, this action is currently stayed pending a determination of defendants’ motion to dismiss the Amended Complaint in the class action lawsuit described above.

OFHEO Investigation. Administrative Notices of Charges were filed by OFHEO against Freddie Mac, and Messrs. Brendsel and Clarke in December 2003. Freddie Mac and the other defendants have moved, among other things, to dismiss the Notices of Charges brought against each of them by OFHEO. The motions are pending. Freddie Mac intends to comply fully with any valid and effective order that OFHEO may issue.

SEC Formal Investigation and U.S. Attorney’s Criminal Investigation. These investigations are continuing and Freddie Mac continues to cooperate fully with them.

At present, it is not possible for us to predict the outcome of the civil litigation, the administrative proceedings or the investigations described above or reasonably to

estimate the amount of loss (or range of possible loss) that might result from adverse results or settlements of these matters, or their effect on our financial condition or results of operations.

Legislative Developments

GSE Regulatory Oversight Bill. While the Senate Banking Committee passed a GSE regulatory oversight bill by a vote of 12-9 on April 1, 2004, we believe that the Senate is unlikely to take further action on the bill this year. We also believe that it is unlikely that the House will consider GSE regulatory oversight legislation this year. However, both the House and the Senate have indicated they are likely to consider GSE regulatory oversight legislation in the next session of Congress. Freddie Mac will continue to work with the Congress, the Administration and other interested parties toward enacting appropriate regulatory oversight legislation.

Regulatory Developments

OFHEO. On April 12, 2004, OFHEO proposed for public comment certain revisions to its corporate governance regulation. On June 14, 2004, Freddie Mac submitted comments to OFHEO on its proposed revisions.

Affordable Housing Goals. On May 3, 2004, the U.S. Department of Housing and Urban Development, or HUD, published for public notice and comment a proposed rule that would establish higher affordable housing mortgage purchase goals for Freddie Mac and Fannie Mae for calendar years 2005 through 2008. The proposed rule would also establish new subgoals for purchase-money mortgages. Freddie Mac is currently analyzing the proposed rule and assessing potential business impacts of the proposed goal and subgoal levels and expects to file comments on HUD's proposal before the close of the extended comment period on July 16, 2004.

Management's preliminary view is that, if the rule were adopted as proposed and under certain market conditions, the rule could have a material adverse impact on our results of operations in future years as a result of increased credit losses on purchases of goal-qualifying mortgages or reduced purchases of non-goal-qualifying mortgages. If a final rule were to be adopted substantially as proposed, Freddie Mac would take measures to reduce or eliminate material adverse business impacts; however, there could be no assurance that any such measures would be fully successful.

At the conclusion of the rulemaking process, HUD may promulgate a final rule that differs from, or is the same as, the proposed rule based upon the comments that it receives, or HUD may withdraw the proposed rule entirely. Consequently, we are unable to predict with certainty the future impact of any final rule on Freddie Mac's business operations, financial condition or results of operations.

Congressional Inquiry Regarding Certain Affordable Housing Transactions. On April 27 and May 7, 2004, Freddie Mac received letters from the House of

Representatives Committee on Financial Services requesting information pertaining to certain transactions, entered into in whole or in part, for the purpose of meeting the affordable housing goals for calendar years 2001, 2002 and 2003. Freddie Mac fully complied with the request for information.

HUD Inquiry Regarding Certain Affordable Housing Transactions. On May 4, 2004, Freddie Mac received a letter from HUD requesting information pertaining to certain transactions entered into in calendar years 2001-2003. As part of the information request, HUD asked Freddie Mac to describe how each identified transaction complies with HUD's goals counting rules for counting units financed in each transaction toward the housing goals in 2003. Freddie Mac fully complied with the request for information.

As discussed in our Information Statement dated February 27, 2004, HUD could compel us to submit a housing plan to meet the housing goals if we were to fail to meet any of them.

FORWARD-LOOKING STATEMENTS

We regularly communicate information concerning our business activities to investors, securities analysts, the news media and others as part of our normal operations. Some of these communications include "forward-looking statements" pertaining to our current expectations about our future business plans, results of operations and financial condition. Forward-looking statements are typically accompanied by, and identified with, terms such as "anticipates," "believes," "expects," "intends," "objectives," "will," "may" and similar phrases. Our June 30, 2004 press release (and this Appendix I) include forward-looking statements. These statements are based on current plans, estimates and projections, and you should not rely on them. Forward-looking statements involve known and unknown risks, uncertainties and other factors, some of which are beyond Freddie Mac's control. Factors that could cause actual results to differ materially from the expectations expressed in these and other forward-looking statements by management include, among others:

- Changes in the level and volatility of interest rates, house prices, employment rates and the general economy;
- Changes in our strategies for and results of credit loss mitigation, interest-rate and other market risk management activities and investment activities;
- The availability of debt funding and equity capital in sufficient quantity and at attractive rates to support continued growth in our retained portfolio, to refinance maturing debt and to meet regulatory capital standards;
- Actions by governmental entities, securities rating agencies or others that could adversely affect the supply or cost of equity capital or debt financing available to us;
- The availability from acceptable counterparties of options, interest-rate and currency swaps, and other derivative financial instruments, or derivatives, of

the types and in the quantities needed for investment funding and risk management purposes;

- The rate of growth in total outstanding U.S. residential mortgage debt;
- The size of the residential mortgage market;
- Borrower preferences for fixed-rate mortgages or adjustable-rate mortgages, which we refer to as ARMs;
- Preferences of originators to sell mortgages into the secondary market;
- Changes in investor preferences for mortgage loans and mortgage-related and debt securities versus other investments;
- Competition in the mortgage market and in the market for mortgage-related and debt securities;
- Our ability to effectively manage operational risk;
- Our ability to implement solutions to business processing systems issues;
- Our ability to effectively and timely implement the remediation plan undertaken as a result of the restatement of our financial statements and the consent order entered into with our safety and soundness regulator OFHEO including in particular initiatives relating to technical infrastructure and controls over financial reporting;
- Developments in, outcomes of, and costs associated with other government investigations and civil litigation in which we are involved;
- Significant business disruptions resulting from acts of war or terrorism;
- The occurrence of a major natural or other disaster in a geographic area in which our total mortgage portfolio is heavily concentrated;
- The degree to which our business and financial forecasting methods accurately predict actual results;
- The impact of new accounting standards, including the timely development of supporting systems; and
- Changes in the legislative or regulatory environment, affordable housing goals, regulatory capital requirements (including the temporary 30 percent target minimum capital surplus requirement imposed on us by OFHEO in January 2004) or our Congressional charter.

We undertake no obligation to update these forward-looking statements to reflect events or circumstances after the date of the press release that this appendix accompanies, or to reflect the occurrence of unanticipated events.